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In The

Supreme Court of the United States

October Term, 1978

No. 78-1202

VINCENT F. CHIARELLA,

Petitioner,

-against-

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1978

No. . . . . .

VINCENT F. CHIARELLA,

Petitioner,

- against -

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Vincent F. Chiarella, petitioner herein, prays that a writ of certiorari issue to review the judgment entered in this criminal case on November 29, 1978 by the United States Court of Appeals for the Second Circuit.

Opinions of the Courts Below

The opinion and judgment of the United States Court of Appeals for the Second Circuit sought to be reviewed is reproduced in Appendix A and is not yet

officially reported. The opinion of the United States District Court for the Southern District of New York (Owen, D.J.) is reproduced in Appendix B and is published at 450 F. Supp. 95.

Jurisdiction of the Supreme Court

The judgment of the United States Court of Appeals for the Second Circuit was entered on November 29, 1978. Petitioner's timely petition to the Second Circuit for rehearing with a suggestion for rehearing in banc was denied on January 4, 1979. Title 28, United States Code, Section 1254(1) and Rule 22(2) of the United States Supreme Court Rules confer jurisdiction on this Court to review the judgment in question by a writ of certiorari.

Questions Presented for Review

1. Does the purchaser of stock in the open market who fails to disclose material, nonpublic information about the issuer of the stock violate Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 where the purchaser has no fiduciary relationship with the issuer and where the information was obtained from and created by a source wholly outside and unrelated to the issuer?

2. Does the Second Circuit's retroactive application of its new and expansive interpretation of Section 10(b) and Rule 10b-5 to sustain petitioner's conviction violate the Due Process Clause of the Fifth Amendment?

3. In a criminal case charging violations of Section 10(b) and Rule 10b-5, did the trial court violate this Court's holding in Ernst & Ernst v. Hochfelder by refusing to instruct the jury that "intent to defraud" was a requisite element of the crime?

4. Did the trial court err in admitting into evidence at petitioner's federal criminal trial a confidential statement - in this case tantamount to a confession - required to be made by petitioner to the New York State Department of Labor as a condition of seeking unemployment benefits when New York law makes the statement absolutely privileged from disclosure and makes disclosure of that statement a criminal act?

Constitutional Provisions, Statutes And Regulations Involved

CONSTITUTION:

Fifth Amendment

STATUTES:

15 U.S.C. §78j(b)
15 U.S.C. §78ff(a)
Rule 501, Federal Rules of Evidence
New York Labor Law, §537

REGULATIONS:

17 C.F.R. §240.10b-5

Each of the above is set forth in Appendix C.

Statement of The Case

Introduction

The United States Court of Appeals for the Second Circuit, in the context of affirming petitioner's conviction, announced a new and drastically expansive interpretation of Section 10(b) and Rule 10b-5. Departing from all prior law and particularly its own decisional law, the Second Circuit ruled that a trader's regular access to market information, irrespective of source, places him in a special relationship with all buyers and sellers with whom he deals and his failure to disclose material nonpublic information he obtains through such access and uses in connection with his purchase of stock violates §10(b) and Rule 10b-5.

Never before has there been a criminal prosecution under §10(b) for the purchase of a corporation's stock on the basis of undisclosed material nonpublic information even where the purchaser is an "insider" of the corporation. Nor has there ever been a litigation in which even civil liability for nondisclosure has been imposed under §10(b) on anyone other than an "insider," the "tippee" of an "insider" or a trader whose information originated inside the corporation whose shares are traded.

Yet in this criminal case, with no basis in prior law, the Second Circuit enlarged the scope of §10(b) and then retroactively found petitioner's conduct to fall within the enlarged scope of the statute. We submit that the Second Circuit's expansion of §10(b) is erroneous

and in conflict with all prior judicial constructions of §10(b) and this Court's recent caveats that §10(b) is to be construed narrowly. Moreover, the Court's ex post facto application of its expansive interpretation of §10(b) to affirm petitioner's conviction violates due process.

Certiorari should be granted to review the Second Circuit's departure from prior law and its ex post facto application of its new and expansive definition of §10(b) liability in this important case of first impression.

Statement of Essential Facts

Petitioner was employed as a "mark-up man" in the composing room at Pandick Press, a financial printing establishment in New York City. During the course of his employment in 1975 and 1976, petitioner worked on setting into type "tender offer" disclosure statements for Pandick's customers--the tender offerors. In each case relevant here, petitioner was able to deduce the identity of the corporation targeted for takeover (i.e., the "target") from data disclosed in the type set documents and by decoding the fictitious target names used in preliminary drafts. Petitioner then purchased shares of the targets' stock.

After agreeing with the SEC in a consent decree to disgorge his profits to those who sold him target shares, petitioner was fired by Pandick and then indicted on 17 counts* charging viola-

*The 17 counts of the indictment represent 17 separate purchases of target stock made by petitioner over the course of five tender offers by five Pandick customers.

of §10(b) and Rule 10b-5.

A pretrial motion to dismiss the indictment upon the ground that the conduct alleged was not within the embrace of §10(b) and Rule 10b-5 because the nonpublic information utilized originated with the offeror corporations not the target corporations and hence petitioner was under no duty to disclose the information to selling target shareholders was denied in a written opinion (Appendix B). Following trial in the United States District Court for the Southern District of New York before the Honorable Richard Owen and a jury, petitioner was convicted on all counts and sentenced to a term of imprisonment of one year with all but one month suspended on each of counts one through thirteen, to run concurrently, and to a term of probation of five years on counts fourteen through seventeen.

On appeal to the United States Court of Appeals for the Second Circuit, petitioner again claimed that the conduct charged did not fall within the scope of §10(b) and Rule 10b-5. On November 29, 1978, a divided panel of the Second Circuit (Kaufman, Ch. J. and Smith, J.; and Meskill, J., dissenting) announced a new and expansive interpretation of §10(b) and Rule 10b-5 and, relying on its new interpretation of §10(b) and Rule 10b-5, affirmed petitioner's conviction (Appendix A).

Petitioner's motion for rehearing with a suggestion for rehearing in banc was denied on January 4, 1979.

REASONS FOR GRANTING THE WRIT

POINT I

The Second Circuit's Expansion of Section 10(b) Liability Is Without Precedent and Conflicts with Its Own Prior Decisions, this Court's Decisions, the Rulings of other Federal Courts and Congressional Intent

Prior to the Second Circuit's opinion in this case, the undeviating judicial interpretation of the broad and generic antifraud provisions of Section 10(b) and Rule 10b-5 relating to "silence" was that nondisclosure was not "fraud" in all cases. It was settled law that liability occurred only when such nondisclosure was in breach of a duty to disclose arising out of a fiduciary relationship between the trader or the original source of the information and the issuer. See, Strong v. Repide, 213 U.S. 419 (1909); Frigitemp Corp. v. Financial Dynamics, Inc., 524 F. 2d 275, 282 (2d Cir. 1975); Schein v. Chasen, 478 F. 2d 817, 823 (2d Cir. 1973), vacated on other grounds, 416 U.S. 386 (1974); SEC v. Great American Industries, Inc., 470 F. 2d 453, 460 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 920 (1969); General Time Corp. v. Talley Industries, Inc., 403 F. 2d 159, 164 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969); Kohler v. Kohler Co., 319 F. 2d 634, 652 (7th Cir. 1963); Speed v. Transamerica Corp., 99 F. Supp. 808, 828-829 (D. Del. 1951); Diamond v. Oreamuno, 24 N.Y. 2d 494, 248 N.E. 2d 910 (1969); In the Matter of Cady, Roberts & Co., 40 S.E.C. 907 (1961).

The requirement of a nexus between the trader, the information and the issuer was first formulated by the SEC itself in its seminal decision of Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961), was relied upon by the Second Circuit en banc in the landmark case of SEC v. Texas Gulf Sulphur, 401 F. 2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969)*, and lies at the core of every nondisclosure case decided under Section 10(b) and Rule 10b-5.

So firmly entrenched is this requirement of a nexus between the trader, his information and the issuer of the shares traded that in 1972 the Second Circuit wrote:

> "The essential purpose of Rule 10b-5 as we have stated time and again, is to prevent corporate insiders and their tippees from taking unfair advantage of the uninformed outsiders." Radiation Dynamics, Inc. v. Goldmuntz, 464 F. 2d 876, 890 (2d Cir. 1972).

The legislative history of §10(b)

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*Interestingly, in opposing certiorari in SEC v. Texas Gulf Sulphur, supra, the SEC itself acknowledged that the duty to disclose arises out of the fiduciary obligation a corporate "insider" owes the corporation's shareholders. (See Brief for the SEC in opposition to petition for a writ of certiorari in Coates v. SEC, No. 68-897, p. 17).

too makes it clear that only nondisclosure in breach of a duty to disclose arising out of a relationship between the trader or the source of information and the issuer of the shares traded violates §10(b). See, S. Rep. No. 1455, 73d Cong., 2d Sess. (1934), pp. 55, 67-68; H. Rep. No. 1383, 73d Cong., 2d. Sess. (1934), pp. 5-6, 11, 13; 78 Cong. Rec. 7861-7862, 8037, 8038 (1934). See also the American Law Institute's Proposed Official Draft of the Federal Securities Code, §1603 (1978).

The facts in this case are undisputed that petitioner had no relationship whatever with the issuer corporations (i.e., targets) and that his information was derived from a source wholly outside the issuer, namely the offeror corporations which created the information. Thus, petitioner owed no duty of disclosure to the issuers' shareholders who sold him their shares in the open market because his purchases were based on information obtained from outside the issuer and not by virtue of exploiting any relationships with the issuer.

It is for exactly the same reason that the Second Circuit and other courts have held that the common practice of open market purchase by a prospective tender offeror of shares of target stock without disclosure of the impending tender offer is not a Rule 10b-5 violation.

In General Time Corp. v. Talley Industries, Inc., 403 F. 2d 159 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969), Talley Industries acquired shares of General Time Corp. on the open market without disclosing its plan for a merger with General Time "whose terms might be more favorable than the price paid for

the stock being acquired." The Second Circuit held that there was no violation of Rule 10b-5 because the purchaser of the shares was not utilizing information of and had no fiduciary relation with the target-issuer. Judge Friendly wrote as follows (id., 403 F. 2d, at 164):

> "We know of no rule of law . . . that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale. . . ."*

Similarly, in Pacific Insurance Co. of N.Y. v. Blot, 267 F. Supp. 956, 957, n. 2 (S.D.N.Y. 1967), Judge Herlands stated:

> "The Court entertains grave doubt whether the alleged failure by the defendant, an 'outsider,' to disclose to selling shareholders the impending tender offer . . . constitutes a violation of Rule 10b-5."

---

*The Circuit's panel majority found petitioner's reliance on General Time Corp. v. Talley Industries, Inc., supra - a case we submit is dispositive on the issue herein--to be "ironic" and "misused" (Appendix A, p. A12) because purchases of target shares by a tender offeror is accompanied by economic risk whereas petitioner, the offeror's tippee, took "no economic risk whatsoever" (id.).

And in Mills v. Sarjem Corp., 133 F. Supp. 753, 764-765 (D. N.J. 1955), the court wrote:

> "The cases imposing a duty on the part of a purchaser of shares of stock to disclose his knowledge of future prospects and plans all involve situations where the purchaser holds a fiduciary

---

(ftn. contd.)

Assuming arguendo that such a definitive difference in risk taking exists, there is simply no authority whatever for the proposition that the degree of risk assumed by a trader trading on the basis of material, nonpublic information is at all relevant to distinguish between noncriminal conduct and felonious conduct.

The majority also sought to distinguish General Time by the fact that petitioner's use of information he obtained from tender offerors was in "violation of his duties as an agent" (Appendix A, p. A13) whereas Talley's purchase of General Time shares was based on information Talley itself created. The distinction, however, is legally impotent. This Court has specifically held that Rule 10b-5 violations are not made out by "all breaches of fiduciary duty in connection with a securities transaction." Santa Fe Industries v. Green, 430 U.S. 462, 472 (1977).

position and where the knowledge has been obtained by virtue of an 'insider' position."

The treatises on the federal securities laws also teach that the common practice of a prospective offeror making open market purchases of target shares without disclosing an impending tender offer is not a Rule 10b-5 violation. See, Bromberg, A. Securities Law: Fraud (1969, McGraw Hill, Inc.), §6.3 (622); Aranow, E.R., Einhorn, H.A., and Berlstein, G., Developments in Tender Offers for Corporate Control, p. 20 (Columbia University Press, 1977).

The Second Circuit rejected this long and well recognized line of authority as "irrelevant" (Appendix A, p. A6), failed to heed this Court's recent warnings that §10(b) is not to be interpreted expansively (International Brotherhood of Teamsters v. Daniel, __U.S.__, 47 U.S.L.W. 4135, 4136 (Jan. 16, 1979); Santa Fe Industries v. Green, 430 U.S. 462, 472, 480 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 197, 199, and n. 19 (1976), and, in the context of this criminal case, without precedent, formulated the new concept of "market insider" (Appendix A, p. A7-A8) and relied on that concept to affirm. The majority's new and expansive rule for non-disclosure liability under Section 10(b) and Rule 10b-5 is as follows (Appendix A, p. A8):

> "Anyone--corporate insider or not--who regularly receives material nonpublic information may not use that information to trade in securities

> without incurring an affirmative duty to disclose. And if he cannot disclose, [footnote omitted] he must abstain from buying or selling." (Emphasis in the original.)

Reliance by the majority on Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), for creation of its new category of potential 10b-5 violators--"market insiders"--is misplaced. In Affiliated Ute a bank and its employees, acting as transfer agent for selling shareholders, became market makers who were active in encouraging a market for the shareholders' stock. They devised a plan and induced holders of the stock to dispose of their shares without disclosing the market conditions of which they were aware and which, in fact, they had created. The Supreme Court held that this special relationship between transfer agent and selling shareholders imposed an affirmative duty to disclose and failure to do so was in contravention of Section 10(b) and Rule 10b-5. But this Court flatly rejected the concept underpinning the majority's opinion here that regular access to market information alone imposes a duty to disclose. Despite access by the bank and its employees to market information due to their position as transfer agent, the Supreme Court acknowledged that ". . . if the [bank and its employees] had functioned merely as a transfer agent, there would have been no duty of disclosure here."* (Emphasis supplied.)

*This basic distinction was recognized by Judge Meskill in his dissent (Appendix A, p. A28-A29):

Until the instant case it was settled law that conduct identical to petitioner's did not even amount to a civil breach of Rule 10b-5. General Time Corp. v. Talley Industries, Inc., supra. It is cruel, illogical and senseless to impose 17 felony convictions on petitioner for non-disclosure of information when, in a civil context, his "tippers"--the offeror corporations--are free not to disclose.

Certiorari should be granted to review the Second Circuit's departure from prior law and its new and expansive definition in the context of a criminal case of the scope of nondisclosure liability under §10(b) and Rule 10b-5.

(ft. contd.)

> "Thus, it was not the bank's clearly superior, regular access to market information . . . but its actions in undertaking to act for the sellers that rendered its silence equivalent to a scheme to defraud the selling shareholders. Chiarella certainly did not undertake to act for the sellers of the target stock nor did he enter the type of special relationship with them which was determinative in Affiliated Ute." (Emphasis supplied.)

POINT II

The Retroactive Application by the Court of Appeals of its New and Expansive Interpretation of Section 10(b) and Rule 10b-5 to Affirm Petitioner's Conviction Violates Due Process

The Second Circuit's new and expansive interpretation of §10(b) and Rule 10b-5 nondisclosure liability is without precedent and conflicts with all prior judicial interpretations of the statute and rule (see Point I, supra.) The Court of Appeals' unprecedented expansion of nondisclosure liability abandoning the well entrenched and commonly understood sine qua non for 10b-5 nondisclosure liability, to wit, that the information utilized by the trader originate "inside" the corporation whose shares are traded, is not the sole or even principal injustice in this case. Rather, the vice lies in the use by the Court of Appeals of its new definition of liability (regardless of whether right or wrong as a matter of law or policy) after the fact to affirm a criminal conviction.

Dissenting from the panel majority opinion, Judge Meskill was "alarmed" by the Court's disregard of the fair notice requirement so fundamental to the concept of due process and wrote (Appendix A, p. A23):

> "Today's decision expands §10(b) drastically, it does so without clear indication in prior law that this is the next logical step on the path of judicial

development of §10(b), and alarmingly, it does so in the context of a criminal case."

Although the panel majority gave lip service to the fundamental tenet that a criminal conviction cannot be upheld unless "a clear and definite statement of the conduct proscribed antedate[s] the actions alleged to be criminal" (Appendix A, p. A15), it cavalierly termed "irrelevant" the prior "clear and definite" statement of precisely what circumstances trigger Section 10(b) nondisclosure liability and defined a new and expansive triggering circumstance. Such judicial erasure of previously drawn and consistently adhered to lines defining the perimeter of a broadly generic statute and rule and the imposition of new lines expanding that perimeter to include a defendant's conduct after the fact runs afoul of the most fundamental notions of due process. See Marks v. United States, 430 U.S. 188, (1977); Rabe v. Washington, 405 U.S. 313 (1972); Bouie v. City of Columbia, 378 U.S. 347 (1964).

In Bouie v. City of Columbia, supra, defendants were convicted under a South Carolina statute prohibiting trespass--the entry on the premises of another after receiving notice not to enter. The South Carolina Supreme Court affirmed the convictions by interpreting the trespass statute to cover the act of remaining on the premises of another after receiving notice to leave. This Court reversed the convictions and held that the retroactive application of a new and expansive judicial interpretation of a criminal statute violated due process. Mr. Justice Brennan

wrote (id., 378 U.S., at 352-354):

> "There can be no doubt that a deprivation of the right of fair warning can result not only from vague statutory language but also from an unforeseeable and retroactive judicial expansion of narrow and precise statutory language.... [A]n unforeseeable judicial enlargement of a criminal statute, applied retroactively, operates precisely like an ex post facto law, such as Art I, §10, of the Constitution forbids.... If a state legislature is barred by the Ex post Facto Clause from passing such a law, it must follow that a State Supreme Court is barred by the Due Process Clause from achieving precisely the same result by judicial construction." (Emphasis supplied.)

The fact that Section 10(b) and Rule 10b-5 are broadly generic in scope imposing "indefinite and uncertain disclosure obligations" (International Brotherhood of Teamsters v. Daniel, __U.S.__, 47 U.S.L.W. 4135, 4139, [Jan. 16, 1979]) makes retroactive judicial expansion that much more dangerous. Indeed, this Court has repeatedly warned against judicial expansion of the scope of liability under §10(b) and Rule 10b-5 in the context of civil lawsuits. International Brotherhood of Teamsters v. Daniel, supra, 47 U.S.L.W., at 4136, Santa Fe Industries v. Green, 430 U.S. 462, 472, 489 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197, 199, and n.19 (1976). Surely in the context of a criminal case where penal statutes must

be strictly construed in favor of an accused (United States v. United States Gypsum Co., __U.S.__, 98 S.Ct. 2864, 2873 [1978]; Rewis v. United States, 401 U.S. 808, 812 [1971]), judicial expansion of the scope of liability is particularly offensive to due process. And in the case at bar this is especially true since the Second Circuit had previously interpreted §10(b) and Rule 10b-5 as not embracing the very conduct charged against petitioner. See General Time Corp. v. Tally Industries, 403 F.2d 159, 164 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969).

The Court of Appeals panel majority relied on signs posted by Pandick warning its employees against the use of confidential informaton and the possibility of criminal liability and several civil consent decrees settling SEC lawsuits for the proposition that petitioner "manifestly had adequate notice that his trading in target stock could subject him to criminal liability" (Appendix A, p. A15). But any notice obtained from Pandick's or its lawyer's views of what the law "could be or from an enforcement agency's commencement of civil lawsuits and acceptance of civil settlements with no litigation is "manifestly" not the notice and predictability due process requires.

In Bouie, supra, this Court rejected the contention that defendants had had adequate notice of the violation because of a chain with a "no trespassing" sign attached had been placed on the premises by an employee of the owner (id., 378 U.S. 347, 355, n.5):

> "The determination whether a criminal statute provides fair warning of its prohibitions must be made on the basis of the statute itself and the other pertinent law, rather than on the basis of an ad hoc appraisal of the subjective expectations of particular defendants."

And with respect to the SEC's view of the law this Court has on a number of recent occasions rejected the SEC's interpretation of various provisions of the Securities Act. See, International Brotherhood of Teamsters v. Daniel, supra, 47 U.S.L.W., at 4138, and cases cited in n. 20.

The absence of the "clear and definite" statement of law antedating petitioner's 1975 and 1976 conduct required by due process is conceded by Chief Judge Kaufman's own telling language (Appendix A, p. A17, n. 18):

> "The sign merely informed appellant of the SEC's view of the law--a view we today hold was correct." (Emphasis supplied.)

But a holding of first impression over vigorous dissent and in conflict with all prior judicial authority interpreting Section 10(b) that an enforcement agency's "view of the law. . . was correct" simply cannot, consistent with due process, serve to justify the affirmance of petitioner's conviction.

Certiorari should be granted to correct the serious due process violations arising from the Second Circuit's ex post facto expansion of §10(b) and Rule 10b-5 nondisclosure liability.

POINT III

The Second Circuit's Holding that Intent to Defraud Is Not an Essential Element of Section 10(b) and Rule 10b-5 Is In Direct Conflict With Supreme Court Law

Despite the unambiguous holding of Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976), that in an action charging Section 10(b) and Rule 10b-5 violations it is necessary to plead and prove "'scienter'--intent to deceive, manipulate, or defraud," the Second Circuit concluded that "Judge Owen correctly refused to charge the jury that the Government must prove specific intent to defraud" (Appendix A, p. A20). The Circuit's reliance on United States v. Peltz, 433 F. 2d 48 (2d Cir. 1970), cert. denied, 401 U.S. 955 (1971) and United States v. Dixon, 536 F. 2d 1388 (2d Cir. 1976) to support its holding is erroneous in that those cases had nothing to do with the requisite mental element of Section 10(b) and Rule 10b-5 but dealt with the general penalty provision of the 1934 Act, Section 32(a).

The trial court's error in charging the jury was that it permitted the jury to find that "willfulness" under Section 32(a) and the Peltz and Dixon formulation of "a realization of wrongful conduct" satisfied the scienter requirement of §10(b) and Rule 10b-5 and failed and refused to charge "intent to defraud" as an essential and distinct element necessary to sustain a

charge of violating that section and Rule.*

Certiorari should be granted to review the Second Circuit's refusal to follow Supreme Court law on the important issue of scienter in §10(b) cases and especially in this criminal case.

POINT IV

The Admission into Evidence of a Damaging Statement--in Effect a Full Confession--Petitioner Made to the New York State Department of Labor as a Prerequisite to Seeking Unemployment Benefits Violated a Specific New York Statute Proscribing the Disclosure of Such Statements and Constituted Reversible Error

Over strenuous defense objection the trial court admitted into evidence a statement made by petitioner to the New York Department of Labor setting forth his view of the reasons for his having been terminated from employment as a printer at Pandick Press. The statement, tantamount to a confession in this case, was required

*Insofar as United States v. Charnay, 537 F. 2d 341 (9th Cir. 1976) can be read for the proposition that "awareness of wrongdoing" satisfies the scienter requirement of Section 10(b) the case directly conflicts with Hochfelder.

by law to be made by petitioner in connection with the processing of his appeal from an initial denial of unemployment benefits. Petitioner, promised by the state before he spoke that his statement would not be released under any circumstances, told the Department of Labor:

> "I was discharged for violations of the company rules re: disclosure of client information. The allegation is true. It was a matter of printing of stock tender offers and I utilized the information for myself. . . ."

The Department of Labor's promise of confidentiality was mandated by New York State law. Section 537 of New York's Labor Law specifically and absolutely prohibits the disclosure of information the Department of Labor acquires from employers or employees pursuant to enforcing the unemployment insurance law. (N.Y. Labor Law, §537[1]) (see Appendix C). Indeed, the public policy underlying the nondisclosure provision was regarded so seriously by the legislature that violation of the provision was made a criminal offense (N.Y. Labor Law, §537[2]) (see Appendix C). And the case law establishes that the statutory nondisclosure provision is mandatory. See, Simpson v. Oil Transfer Corp., 75 F. Supp. 819 N.D.N.Y. 1948); Andrews v. Cacchio, 264 App. Div. 791, 35 N.Y. Supp. 2d 259 (2d Dept. 1942); Eston v. Backer, 119 N.Y. Supp. 2d 273 (Sup. Ct. Queens Co. 1953).

The admissibility in a federal criminal trial of a statement absolutely privileged from disclosure under state law is governed by Rule 501 of the Federal Rules of

Evidence. That rule, in relevant part, provides:

> "Except as otherwise . . . provided by Act of Congress. . . the privilege of a . . . person . . . shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience."

See also, Wolfe v. United States, 291 U.S. 7 (1934); Funk v. United States, 290 U.S. 371 (1933).

As originally promulgated by the Supreme Court the Federal Rules of Evidence incorporated 13 specific rules of privilege. Though not adopted by Congress the specific rules (Supreme Court Standards) reflect the Supreme Court's view of the law of privilege as applied in the federal courts and is powerful authority that the rules of privilege stem from "principles of common law as interpreted by the courts of the United States in the light of reason and experience.

One of the Supreme Court rules of privilege mandates that a statement of the type made by petitioner is privileged from disclosure in federal court. Supreme Court Standard 502* provides, in relevant part,

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*Federal case law compellingly supports the view that Supreme Court Standard 502 accurately states federal common law. See, Connecticut Mutual Life Ins. Co. v. Union Trust, 112 U.S. 250 (1884); Herman Brothers

as follows:

> "A person. . . making a return or report required by law to be made has a privilege to refuse to disclose and to prevent any other person from disclosing the return or report, if the law requiring it to be made so provides."

The rule of privilege clearly applies to petitioner's statement to the New York Department of Labor "required by law to be made" which law also prohibits its disclosure.

Certiorari should be granted to correct this important evidentiary error and the trial court's failure to accord the modicum of comity due the state's laws by the federal system.

(ftn. contd.)

Pet Supply, Inc. v. NLRB, 360 F. 2d 176 (6th Cir. 1966); In re Valencia Condensed Milk Co., 240 F. 310 (7th Cir. 1917); Tollefsen v. Phillips, 16 FRD 348 (D. Mass. 1954); In re Reid, 155 F. 933 (D. Mich. 1906); 8 Wigmore, Evidence §2377, pp. 780-781 (McNaughton Rev. 1961).

CONCLUSION

For the reasons stated herein, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 137—August Term, 1978.

(Argued October 3, 1978 Decided November 29, 1978.)

Docket No. 78-1201

UNITED STATES OF AMERICA,

Appellee,

—v.—

VINCENT F. CHIARELLA,

Defendant-Appellant.

Before:

KAUFMAN, *Chief Judge,*
SMITH and MESKILL, *Circuit Judges.*

Appeal from a conviction, after a jury trial, in the United States District Court for the Southern District of New York, Richard Owen, *District Judge,* for willfully misusing material nonpublic information in connection with the purchase and sale of securities, in violation of §§ 10(b) and 32(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78ff(a), and Rule 10b-5.

Affirmed.

STANLEY S. ARKIN, New York, New York (Arkin Arisohn & Cross P.C., Mark S. Arisohn, Lee Cross, of counsel), *for Defendant-Appellant.*

JOHN S. SIFFERT, Assistant United States Attorney, Southern District of New York (Robert B. Fiske, Jr., United States Attorney, Richard D. Weinberg, Assistant United States Attorney, of counsel), *for Appellee*.

KAUFMAN, *Chief Judge*:

The draftsmen of our nation's securities laws, rejecting the philosophy of *caveat emptor*, created a system providing equal access to the information necessary for reasoned and intelligent investment decisions. It is apodictic that betting on a "sure thing' is anathema to the ideal of "fair and honest markets" established as the foundation of this statutory edifice.[1] The present case requires us to apply these principles in the context of a criminal prosecution for trading on advance knowledge of stock market events. Vincent Chiarella used confidential information obtained through his job in a financial printing house to anticipate impending tender offers. He bought cheap and, soon after, sold dear. For these activities, he stands convicted of willfully violating § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. On appeal, he contends that his operations, however nefarious, do not fit the statutory definition of criminal conduct and, moreover, that the trial judge erred in instructing the jury on the crucial issue of intent. He also challenges numerous other aspects of Judge Owen's charge and a host of his rulings on evidentiary matters. We affirm.

I.

Hostile tender offers are the high drama of Wall Street, but they have their tedious aspects. Chief among the latter

1 Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b.

is the vast amount of paper they generate even before the offer is made. Offering and transmittal letters, newspaper announcements, and disclosure statements to be filed in Washington must be prepared before the offeror may invite tenders. These documents are produced by the specialized printing firms that cluster around our centers of finance.

Appellant was a "markup man" in the composing room of one such establishment, Pandick Press. Located in downtown Manhattan, Pandick was readily accessible to law firms and banking houses. When copy from a customer arrived in the shop, it went first to Chiarella. He selected type fonts and page layouts and then passed the manuscript on to be set into type.

Between September 1975 and November 1976, in addition to preparing more mundane documents such as annual reports and proxy statements, Chiarella handled the raw material for five separate takeover bids.[2] To preserve confidentiality for as long as possible—and, most particularly, to avoid an anticipatory rise in the market price of the target company's stock should news of the impending tender offer become public—the type was initially set with certain vital information absent or in code. Thus, when Emhart Corp. sought to purchase control of USM Corp., the documents originally delivered to Pandick read "Arabia Corp." and "USA Corp." Not until the final press run on the night before release were the true names inserted.

The lawyers and investment bankers who coded the document, however, reckoned without Chiarella. Appellant was

2 Four of the transactions were in fact tender offers and one was a merger. The record is unclear which, if any, of the takeover bids were "hostile" in the sense that they were opposed by the target's management. The parties have not treated either distinction as significant.

not merely an ordinary printer, but a knowledgeable stock trader who spoke with his broker as often as ten or fifteen times a day. In each of the five cases, he was able to deduce the name of the target company from other information in the documents—price histories, par values, and the number of letters in the mock corporate names. Then, disregarding notices posted throughout Pandick that use of customer information for personal gain was both illegal and against company rules, he would call his broker and buy shares of the target's stock.

Of course, when each tender offer was publicly announced, the market price of Chiarella's recently purchased shares increased sharply. Chiarella quickly sold out and turned a handsome profit. In the Emhart tender offer, for example, Emhart's lawyers brought the first set of document to Pandick on September 3, 1975. By September 5, Chiarella had concluded that "Arabia" was Emhart and "USA" was USM. On that day, he bought 200 shares of USM common stock for his own account and 100 shares for his father's. On September 9, after the tender offer was announced, he sold all the stock at a profit of $1019.11. Over the five takeover bids covered by the indictment, Chiarella netted more than $30,000.[3]

3

		Purchases			
Target	*Offeror*	*Shares*	*Date*	*Date Sold*	*Profit*
USM	Emhart	300	9/ 5/75	9/ 9/75	$ 1,019.11
Bivlana Foods (Merger)	Colgate-Palmolive	2300	2/ 5/76 to 2/10/76	2/26/76 to 3/16/76	$ 8,948.33
FoodTown Stores	Delhaize Freres	1100	10/11/76	10/21/76 to 12/ 1/76	$ 2,990.30
Booth Newspapers	Times-Mirror	100	10/21/76	10/22/76	$ 914.50
Sprague Electric	General Cable	3200	11/10/76	11/15/76	$16,138.87
				TOTAL PROFIT:	$30,011.39

Unfortunately for Chiarella, this "sure bet" did not last forever. In early 1977, the SEC initiated an investigation into Chiarella's activities. In May, he agreed in a consent decree to disgorge his profits to those who had sold him target stock[4] and, the same day, was discharged by Pandick. Finally, on January 4, 1978, he was indicted on seventeen counts of willful misuse of material[5] nonpublic information in connection with the purchase and sale of securities, purportedly in violation of § 10(b) and Rule 10b-5.[6] After moving unsuccessfully to dismiss the indictment on the

4 *SEC* v. *Chiarella*, No. 77 Civ. 2534 (GLG) (S.D.N.Y. May 24, 1977).

5 The information concerning the impending tender offers was stipulated to be material.

6 The indictment was brought under § 32(a), the penalty provision of the 1934 Act, 15 U.S.C. § 78ff(a):

> Any person who willfully violates any provision of this chapter (other than section 78dd-1 of this title), or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than $10,000, or imprisoned not more than five years, or both, except that when such person is an exchange, a fine not exceeding $500,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

Chiarella made seventeen separate purchases of target stock over the course of the five takeover bids. Each count of the indictment represents a confirmation slip mailed to appellant by his broker following a telephoned buy order. These mailings were sufficient to invoke federal jurisdiction under the securities laws. *Little* v. *United States*, 331 F.2d 287, 292 (8th Cir. 1964); Mathews, *Criminal Prosecution Under the Federal Securities Laws and Related Statutes*, 39 G.W.L. Rev. 901, 921-22 (1971).

ground that it did not charge a crime, he was convicted by the jury on every count.[7] This appeal followed.

II.

Chiarella admits to the activities outlined above. He recognizes, moreover, that since *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969), it has been black letter law that

> anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed. *Id.* at 848.

But because he was not an insider of the target corporations, he argues, he did not owe a fiduciary duty to target shareholders who sold before the tender offer was announced. Thus, he claims, he was not subject to the "disclose or abstain" rule of *Texas Gulf Sulphur*, and, consequently, the indictment fails to charge a violation of Rule 10b-5. We disagree.

A.

That appellant was not an insider of the companies whose securities he traded is true, but irrelevant. A financial printer such as Chiarella is as inside the market itself as one could be.

In practical terms, the services of a financial printing firm are a prerequisite for the successful execution of a tender offer. These auxiliaries of the securities industry are a central, though generaly unheralded, cog in the vital machinery for disseminating information to investors. From his vantage point in the composing room of Pandick Press, Chiarella had access on a regular basis to the most confidential information in the world of finance. Five times in less than fifteen months he obtained knowledge of facts that, when released, would have an immediate and dramatic effect "on the Street."

For the securities markets to function properly, it is essential that those who occupy such strategic places in the market mechanism be forbidden to reap personal gains from information received by virtue of their position. Indeed, Rule 10b-5 prohibits *corporate* insiders from trading on nonpublic *corporate* information only because their ready access to the intimate details of their companies' problems and prospects gives them an unfair advantage over persons with whom they deal. *See, e.g., Texas Gulf Sulphur, supra,* 401 F.2d at 848 ("[T]he Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."); *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951); Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. Pa. L. Rev. 798, 818 (1973). Yet even the most unscrupulous officer or director could scarcely have a greater opportunity to reap sure profits than market insider Chiarella had by virtue of the market information

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7 Judge Owen's decision on the motion to dismiss is reported at 450 F. Supp. 95 (S.D.N.Y. 1978).

Appellant was sentenced to concurrent terms of one year on counts one through thirteen, to be suspended following one month's imprisonment. Imposition of sentence on the remaining counts was suspended, and he was placed on probation for five years following his release from prison.

at his disposal.[8] Accordingly, we believe that the principle underlying *Texas Gulf Sulphur* is not so narrow as Chiarella contends. In enacting the securities laws, Congress did not limit itself to protecting shareholders from the peculations of their officers and directors. A major purpose of the antifraud provisions was to "protect the integrity of the marketplace in which securities are traded." *United States* v. *Brown*, 555 F.2d 336, 339 (2d Cir. 1977). *Anyone*—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose. And if he cannot disclose,[9] he must abstain from buying or selling.

The American Law Institute's *Federal Securities Code* has suggested a category of "quasi-insiders" that bears a strong resemblance to the concept of market insider developed above. *See id.* § 1603, comment 3(d), at 538-39 (Proposed Official Draft 1978). In rejecting a *per se* disclose-or-abstain rule for quasi-insiders, the ALI appeared primarily concerned with defining the scope of the category. *Id.* It therefore chose not to include these individuals

8 "Market information" refers to information that affects the price of a company's securities without affecting the firm's earning power or assets. *See* Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 799. Examples include information that an investment adviser will shortly issue a "buy" recommendation or that a large stockholder is seeking to unload his shares—or that a tender offer will soon be made for the company's stock. Of course, from the point of view of a shareholder who sells his stock on the day before the price jumps sharply upward, it matters little whether the cause of the rise was news of an ore strike, *see Texas Gulf Sulphur*, *supra*, or, as here, the announcement of a tender offer. *See* ALI Federal Securities Code § 1603, comment 2(j), at 531-32; *Oppenheimer & Co.*, Exch. Act Rel. No. 12319, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,331, at 86,415 & n.3 (1976).

9 Chiarella, of course, was disabled from disclosing his knowledge of the tender offers by his duty to his employer not to reveal clients' confidences.

in the "insider trading" section of the *Code* (§ 1603). But the Institute specifically indicated that "egregious" cases would fall under the proscription of § 1602, its recodification of Rule 10b-5. *Code, supra*, at 539. Compare Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 819-24. A test of "regular access to market information" appears to us to provide a workable rule. There should be no greater difficulty in resolving close cases than is inherent in determining who is a "corporate insider" under *Texas Gulf Sulphur*. *See Code, supra*, § 1603, comment 3(e), at 540. In any event, we believe Chiarella's conduct was sufficiently egregious to fit the most restrictive definition of a quasi-insider who would be barred from trading by the general provisions of § 1602.

A duty to disclose arising out of regular access to market information is not a stranger to the world of 10b-5. In *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972), the First Security Bank of Utah acted as transfer agent for shares of the Ute Development Corporation, which was created by the federal government to hold assets for a group of mixed-blood Ute Indians. There were effectively two separate markets for the shares—a primary market consisting of Indians selling to whites through the Bank, and a resale market consisting entirely of whites. The price per share was significantly higher in the resale market, but the Indians did not know of the existence of the resale market nor, of course, of the price differential. Gale and Haslem, two employees of the Bank, bought from Indians and sold to whites, thereby realizing substantial profits. The Supreme Court held that the employees' position at the center of the two markets gave rise to a Rule 10b-5 affirmative duty to disclose. 406 U.S. at 153.[10]

10 Specifically, the Court applied our decision in *Chasins* v. *Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1971), to hold that Gale and

B.

We are not to be understood as holding that no one may trade on nonpublic market information without incurring a duty to disclose. Indeed, as Chiarella has persistently reminded us, a would-be tender offeror may purchase up to 5% of the stock of its prospective target without making any disclosure at all. *General Time Corp.* v. *Talley Industries, Inc.*, 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969); *see* 15 U.S.C. § 78m(d); *Kennecott Copper Corp.* v. *Curtiss-Wright Corp.*, No. 78-7187, slip op. at 4866-70 (2d Cir. Sept. 28, 1978). Because offerors may trade, and because he obtained his information from them, appellant would have us conclude that he, too, could purchase target stock before the tender offer is announced, subject only to the 5% limitation of the Williams Act, 15 U.S.C. §§ 78m(d), 78n(d). But the offerors and Chiarella occupy entirely different positions with respect to trading on news of an impending tender offer.

It is clear, at the outset, that an offeror is not a "market insider" as this term has been defined above. It does not regularly receive nonpublic information concerning any

Haslem were *de facto* market makers and obliged to reveal that fact to the Indians. Both we and the Supreme Court relied exclusively on Rule 10b-5 to establish the duty, and did not look to Rule 15c1-4, which regulates the conduct of broker-dealers. 406 U.S. at 154 n.16; 438 F.2d at 1172-73. *Cf. SEC* v. *Spectrum, Ltd.*, 489 F.2d 535, 541-42 (2d Cir. 1973) ("unique and pivotal role" of legal profession in distribution of securities justifies higher-than-usual standard of conduct).

We disagree with Judge Meskill's narrow reading of *Affiliated Ute Citizens*. It is highly doubtful whether, under the facts of that case, a mere transfer agent would have had access to the detailed price and market information available to the bank employees. Accordingly, the Court's *dictum* that a transfer agent would not incur a duty to disclose, 406 U.S. at 151-52, should not be interpreted as a holding precluding liability of Chiarella, who *did* have regular access to nonpublic information of vital concern to investors.

stock but its own.[11] Indeed, with respect to tender offers, it does not receive information but creates it.

Moreover, in making a tender offer at a premium above the pre-offer market price, the offeror is undertaking a substantial economic risk that his tempting target will prove to be a "white elephant." Although it knows that the price of the target stock will rise when the takeover bid is announced, the offeror has no alchemic power to transform this knowledge into a certain profit. The only reason it can be confident that its purchases will soon appreciate in value is that it will soon place a much greater sum of money at risk. When the price goes up, the offeror will be *buying*, not selling.

The offeror's pre-offer market purchases thus represent its willingness to back its judgment that target stock is undervalued by the market. This course of action is entirely consistent with the principles underlying the securities laws. The legislative history of the 1934 Act emphasizes

> [t]he idea of a free and open public market [that] is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price.

H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934); *accord*, S. Rep. No. 1455, 73d Cong., 2d Sess. 81 (1934). Nor are these principles in any way diminished by the 5% limit on pre-offer market purchases established by the Williams Act. 15 U.S.C. §§ 78m(d), 78n(d). That legislation was not designed to interfere with an offeror's exercise of its

11 When it does, of course, it may be liable as an ordinary insider. *Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787, 796 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970).

economic judgment. Rather, its principal purpose was to prevent the "stampede effect" that the publicity associated with tender offers has on target shareholders. *See, e.g., Rondeau* v. *Mosinee Paper Co.*, 422 U.S. 49, 58 & n.8 (1975); E. Aranow, H. Einhorn & G. Berlstein, *Developments in Tender Offers for Corporate Control* 10-16 (1977).

Let us now consider Chiarella. In stark contrast to the offerors, he has taken no economic risk whatsoever. Indeed, his "investments" were less speculative than those of the defendants in *A.T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (2d Cir. 1967). The Perlows ordered stock from their broker but refused to pay when the price had not gone up by settlement date. Chiarella, however, had virtually certain knowledge that he could sell out at a substantial profit.[12] Moreover, as in *Perlow*, Chiarella's market activity created an artificial demand for target stock that had a distorting effect on the free play of market forces envisioned by the securities laws. *See id.* at 397; Schotland, *Unsafe at Any Price: A Reply to Manne*, Insider Trading and the Stock Market, 53 Va. L. Rev. 1425, 1448-52 (1967).

Viewed in this light, Chiarella's reliance upon *General Time Corp.* v. *Talley Industries, Inc., supra*, is ironic. To support his assertion that *General Time* limits the affirmative duty to disclose to outsiders of the issuer, Chiarella misuses Judge Friendly's comment that:

> We know of no rule of law, applicable at the time, that a purchaser of stock, who was not an "insider" and had no fiduciary relation to a prospective seller, had any obligation to reveal *circumstances that might raise a seller's demands and thus abort the sale.* 403 F.2d at 164 (emphasis added).[13]

12 Appellant's counsel suggested at oral argument that Chiarella bore the risk that tender offer plans would collapse between the time he purchased target stock and the date set for the public announcement. We reject any contention that this remote and nebulous possibility is at all comparable to the risk borne by the offeror.

Appellant would place himself in the shoes of the offerors, but the shoes do not fit. Chiarella was not a "tippee" of Pandick's clients, with liability derivative only through them. In clear violation of his duties as agent, *Restatement (2d) Agency* § 395, he converted to his personal use confidential information entrusted to him in the course of his employment. He may not relieve himself of his market insider's duty of disclosure by claiming the protection of persons he has defrauded.[14]

Indeed by entering the market for target stock on the basis of advance knowledge of a tender offer, Chiarella exerted upward pressure on the price of the stock. In this manner, he achieved precisely the result Judge Friendly so assiduously sought to avoid in *General Time*. *See* E. Ara-

13 The allusion to a change in the applicable law refers to enactment of the Williams Act, which became effective after the transactions at issue in *General Time*. As we indicated earlier, that legislation does not affect the existence of a market insider's duty to disclose.

14 This suffices to dispose of appellant's contention that Judge Owen erred in permitting the prosecutor to argue that Chiarella's conduct defrauded the offerors as well as the sellers. The prosecutor was making a legitimate response to the principal pillar of the defense theory of the case, that Chiarella could trade because the offerors could trade. In any event, the indictment fairly charges Chiarella violated Rule 10b-5 by converting offerors' confidential information to his own use. It not only alleged that appellant's activities "operated as a fraud and deceit upon the sellers of the aforementioned securities," it also charged a "scheme to defraud" in general terms. Clearly, violation of an agent's duty to respect client confidences, *Restatement (2d) Agency* § 395, transgresses Rule 10b-5 where, as here, the converted information both concerned securities and was used to purchase and sell securities. *Cf. Superintendent of Insurance* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 9-10 & n.7 (1971); *United States* v. *Brown, supra*; *A.T. Brod & Co.* v. *Perlow, supra*.

now, H. Einhorn & G. Berlstein, *supra*, at 20; Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 815.[15]

We conclude, therefore, that Chiarella's conduct violated Rule 10b-5, and the indictment accordingly charges a crime.[16] Congress enacted § 10(b) to prohibit conduct

15 We wish to make it clear that we are not relying on any concept of "business purpose" in distinguishing Chiarella from Pandick's clients, whose confidential information appellant converted to his own use. In this respect, we differ with Judge Owen, who relied at least in part on the offerors' "presumptively legitimate business purpose to promote economic growth," 450 F. Supp. at 97. We agree with appellant that "business purpose" cannot be dispositive of liability under Rule 10b-5. *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977).

But the presence or absence of a business purpose has no bearing on Chiarella's liability for defrauding the sellers. That arises solely from appellant's position as a market insider and his breach of his resulting duty not to trade on market information without disclosure. With respect to the sellers, the economic analysis adumbrated in the text serves only to demonstrate why Chiarella may not claim the benefits of the *General Time* doctrine. Equally, business purpose is irrelevant to Chiarella's culpability for defrauding the offerors. His guilt there arises from a conversion of property—Pandick's clients' information—that is intimately connected with the purchase and sale of securities. *See* note 14 *supra*.

In any event, *Santa Fe Industries* arose on facts entirely different from those of the case at bar. In *Santa Fe*, the question was whether lack of business purpose would create liability under Rule 10b-5 even when all required disclosures were made. 430 U.S. at 474-77. Chiarella, of course, made no disclosure whatsoever.

Moreover, Chiarella's contention that there was no fraud because the sellers did not suffer injury by reason of his conduct is without merit. Appellant suggests that, even were he to have abstained from trading, the target shareholders would still have placed their orders to sell. Consequently, his failure to abstain was not a "but for" cause of the losses the sellers incurred by unloading their shares before the tender offer announcements. This argument, however, is weightless. It would be equally applicable to the shareholders in *Texas Gulf Sulphur*, who would have sold even had the TGS insiders not been purchasing on their advance knowledge of the company's ore strike.

16 We are unpersuaded by our dissenting brother's argument that Rule 10b-5 must be construed more narrowly in criminal prosecutions than in civil enforcement actions. Section 32(a) of the 1934 Act, 15 U.S.C. § 78ff(a), provides criminal penalties for willful violations of "any rule or regulation . . . the violation of which is made unlawful." (emphasis added) It is well-established that, except for issues of intent

that destroyed confidence in the securities markets. *See, e.g.*, 15 U.S.C. § 78b; *United States* v. *Brown*, *supra*. The section was specifically designed to prohibit "those manipulative and deceptive practices which have been demonstrated to fulfill no useful function." S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934). It is difficult to imagine conduct less useful, or more destructive of public confidence in the integrity of our securities markets, than Chiarella's.

C.

Appellant contends that interpreting Rule 10b-5 to impose an affirmative duty of disclosure on a person other than a corporate insider would be so novel a construction of the Rule as to violate the fair notice element of due process. We believe, however, that today's holding is but a logical application of the congressional policies underlying the rule of *Texas Gulf Sulphur*. That no prior litigated case has involved the precise fact pattern at issue here is not dispositive. *United States* v. *Brown*, *supra*, 555 F.2d at 339-40; *United States* v. *Charnay*, 537 F.2d 341, 349-50 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976). All that is necessary is that "a clear and definite statement of the conduct proscribed" antedate the actions alleged to be criminal. *United States* v. *Persky*, 520 F.2d 283, 288 (2d Cir. 1975).

Under this principle, Chiarella manifestly had adequate notice that his trading in target stock could subject him to criminal liability. He was not the first printer to have felt the wrath of the SEC. On August 12, 1974, the Com-

and burden of proof, criminal and civil liability under the securities laws are coextensive. *United States* v. *Peltz*, 433 F.2d 48, 53 (2d Cir. 1970) (Friendly, J.), *cert. denied*, 410 U.S. 933 (1971); *United States* v. *Charnay*, 336 F.2d 341, 348 (9th Cir.) (citing cases), *cert. denied*, 429 U.S. 1000 (1976).

mission filed a complaint alleging that various employees of Sorg Printing Co. had engaged in activities identical to Chiarella's. The employees eventually consented to entry of preliminary injunctions against them. *SEC* v. *Sorg Printing Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,034 (S.D.N.Y. March 28, 1975).[17]

The *Sorg* decree was well publicized and aroused widespread concern in the financial printing industry. Pandick undertook to notify its employees that trading on the basis of information contained in customers' copy could violate the securities laws. It prepared 8" x 10" signs, in large, boldface type, reading:

> To All Employees:
>
> The information contained in all type set and printing done by Pandick Press, Inc., is the private and personal property of the customer.
>
> You are forbidden to use any information learned from customer's copy, proofs or printed jobs for your own or anyone else's benefits, friend or family or talking about it except to give or receive instructions. Any violation of this rule will result in your being fired immediately and without warning.
>
> In addition, you are liable to criminal penalties of 5 years in jail and $10,000 fine for each offense.
>
> If you see or hear of anybody violating this, report it immediately to your supervisor or to Mr. Green or Mr. Fertig. Failure to report violations will result in your being fired.

These signs were posted on bulletin boards throughout the Pandick shop before September 5, 1975, when Chiarella made his first purchase of target stock. During the entire fifteen-month period covered by the indictment, the prominent sign over the timeclock where Chiarella punched in and out glared at him daily. On cross-examination, appellant admitted passing the sign at least 640 times. The jury need not have believed his testimony that he never read it.[18] Few malefactors receive such explicit warning of the consequences of their conduct.

III.

We turn now to the second major issue raised on this appeal—the level of intent necessary to support a conviction for criminal violations of Rule 10b-5. Chiarella's state of mind was the only significant issue at trial.

Judge Owen charged the jury that it could not convict Chiarella unless it found that he had acted "knowingly" and "willfully," and defined these terms to mean that "the defendant must be aware of what he was doing and what he was not doing" and that he must be acting deliberately,

17 Since *Sorg*, the SEC has obtained consent devices against three additional printers (not including Chiarella). *SEC* v. *Manderano*, [Current] Fed. Sec. L. Rep. (CCH) ¶96,337 (D.N.J. March 22, 1978); *SEC* v. *Primar Typographers, Inc.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,734 (S.D.N.Y. 1976); *SEC* v. *Ayoub*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,567 (S.D.N.Y. 1976). *Cf. SEC* v. *Healy*, SEC Litigation Rel. No. 6589 (S.D.N.Y. Nov. 13, 1974) (officers of tender offeror).

18 The notice was also printed in the union newspaper, on the back of Chiarella's timecard, and in separate cards distributed to Pandick employees. Chiarella testified that he never read any of these, although he admitted knowing that Sorg employees "violated company policies and they were discharged." At the sentencing hearing, Judge Owen found that Chiarella's testimony that he had not read the notices was perjury beyond a reasonable doubt.

We did not suggest, of course, that the notices posted by Pandick somehow expanded the scope of liability under § 10(b) and Rule 10b-5. Our Brother Meskill misreads us on this point. Chiarella's conduct was rendered illegal by the language and policy of the statute and rule. The sign merely informed appellant of the SEC's view of the law—a view we today hold was correct.

and not as a result of "innocent mistakes, negligence, or inadvertence or other innocent conduct." He concluded:

> All that is necessary for this second element to be satisfied is that the government establish a realization on the defendant's part that he was doing a wrongful act, assuming that you find that Chiarella's conduct was wrongful under the securities law as I have explained in the previous element, and that the knowingly wrongful act involved a significant risk of effecting the violation that occurred. Jt. App. 778a.

This language has been specifically approved for prosecutions brought, like this one, under § 32(a) of the 1934 Act, 15 U.S.C. § 78ff(a), which punishes willful violations of the Act's substantive provisions or of rules promulgated under it. *United States* v. *Peltz*, 433 F.2d 48, 54-55 (2d Cir. 1970), *cert. denied*, 401 U.S. 955 (1971); *United States* v. *Dixon*, 536 F.2d 1388, 1395-97 (2d Cir. 1976).

Chiarella does not dispute that Judge Owen's charge adequately defines the level of intent required by § 32(a) itself. Rather, he contends that when the substantive provisions are § 10(b) and Rule 10b-5, the Government must prove the additional element of specific intent to defraud. In advancing this proposition he cites the statement in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), that a civil action for damages under the antifraud provisions of the 1934 Act must fail absent proof of " 'scienter'—intent to deceive, manipulate, or defraud," *id* at 193.

Courts and commentators alike have noticed, however, that, read as a whole, the *Hochfelder* opinion does not yield such a clear and ineluctable explication of the meaning of "scienter." *See, e.g., Rolf* v. *Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44-47 (2d Cir. 1978), *petition for cert. filed*, 47 U.S.L.W. 3266 (U.S. Oct. 2, 1978) (No. 78-560);

United States v. *Charnay, supra*, 537 F.2d at 357-59; Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5*, 29 Stan. L. Rev. 213, 216-17 (1977). The Court was primarily concerned with rejecting Hochfelder's contention that mere negligent omissions sufficed to establish a claim under Rule 10b-5, and it did not settle fine points of definition. In particular it left open whether reckless conduct is sufficient, 425 U.S. at 193 n.12, and variously described its holding as requiring "some element of scienter," *id.* at 201, and "knowing or intentional misconduct," *id.* at 197. A fair reading of *Hochfelder* indicates that the Court used the term "scienter" only to contrast negligence and not to establish a standard of specific intent to defraud.

Indeed, such fraudulent intent was not required by any of the cases or commentators cited by the *Hochfelder* Court as favoring a scienter requirement in 10b-5 actions, *see* Bucklo, *supra*, at 219 & nn.30 & 31, nor was it generally required at common law, *see id.* at 228-30. And, since *Hochfelder*, we have held that, under some circumstances, reckless disregard of the truth will satisfy the scienter requirement in a private civil action for damages. *Rolf* v. *Blyth, Eastman Dillon & Co., supra*. Finally, the only court to reach the issue has held the *Peltz-Dixon* charge to be consistent with *Hochfelder*. *United States* v. *Charnay, supra*, 537 F.2d at 357-59 (on petition for rehearing in light of *Hochfelder*).

In the case before us, Chiarella was convicted under a charge requiring the jury to find beyond a reasonable doubt that he engaged in "knowingly wrongful" misconduct.[19] We do not believe that *Hochfelder* requires more

19 There is no question as to the adequacy of the evidence to support the verdict. Chiarella admitted knowing that his actions violated company policy and made him liable to discharge. And although he testi-

than this. Accordingly, Judge Owen correctly refused to charge the jury that the Government must prove specific intent to defraud.[20]

IV.

Chiarella's arguments on the issues of intent, however, are not limited to his claim under *Hochfelder*. He asserts that numerous errors in Judge Owen's evidentiary rulings and jury instructions, individually and cumulatively, prevented the jury from fairly considering his contention that he did not have a culpable state of mind. Our examination of the record convinces us that the trial court acted properly in all respects.

For example, the district judge refused to permit Chiarella to testify that he had never heard of anyone being

fied that he thought his conduct was legal (because the offerors had the right to trade) and that he did not believe that "anything criminal would come of it," he admitted on cross-examination that he knew his conduct was "wrong" and "against the SEC." Contrary to Chiarella's suggestion, he was not convicted for violating company policy. His knowledge that he was doing so, however, constituted a culpable state of mind sufficient to satisfy the *Peltz-Dixon* test of willfulness under § 32(a).

20 We also believe that the district judge did not, as Chiarella suggests, direct a verdict of guilty by charging the jury that "in the context of this case, assuming you find the requisite state of mind, a failure by Chiarella to disclose material, nonpublic information in connection with his purchase of stock would constitute deceit." This charge was given as part of the definition of "scheme to defraud" in Rule 10b-5(a). Construction of the words of a statute (and, of course, a rule) is the court's function. *E.g., United States* v. *Santiago*, 528 F.2d 1130, 1135 (2d Cir.), *cert. denied*, 425 U.S. 972 (1976). *United States* v. *United States Gypsum Co.*, 57 L. Ed.2d 854 (1978), is not to the contrary. That case held it an impermissible encroachment on the jury's fact-finding role to charge that defendants are presumed to have intended to fix prices if their conduct would have that effect. *Id.* at 868-75. Here, the trial judge repeatedly told the jury that it must determine Chiarella's state of mind for itself; indeed, the portion quoted as objectionable specifically so states.

prosecuted for what he had done. But under the *Peltz-Dixon* test, the willfulness requirement of § 32(a) is satisfied by a general awareness of wrongful conduct, *Peltz, supra*, at 55, which may exist even if a defendant believes his chicanery is in technical compliance with the law, *Dixon, supra*, at 1396. Chiarella's proffered testimony, therefore, was at best tangentially relevant. Considering the prejudice to the Government that might arise from a suggestion that Chiarella was unfairly singled out for prosecution, Judge Owen did not abuse his broad discretion under Fed. R. Evid. 403 by barring the testimony. *See, e.g., United States* v. *King*, 560 F.2d 122, 128 (2d Cir.), *cert. denied*, 434 U.S. 925 (1977). Similarly, the trial judge did not err in excluding, as irrelevant and prejudicial, evidence that appellant disgorged his profits to the sellers of his target securities. It is difficult to see how Chiarella's state of mind during the operation of his scheme would be illuminated by evidence that afterwards he agreed to an SEC decree requiring restitution. *United States* v. *Post*, 407 F.2d 319, 326-28 (D.C. Cir. 1968), *cert. denied*, 393 U.S. 1092 (1969).[21]

21 We also conclude that it was not error to charge the jury that "the repeated similar acts or conduct in the indictment may be considered circumstantial evidence of unlawful intent." Similar acts evidence is frequently highly probative on issues of intent. *See, e.g.*, Fed. R. Evid. 404(b); *United States* v. *Grady*, 544 F.2d 598, 604-05 (2d Cir. 1976); *United States* v. *Broadway*, 477 F.2d 991, 994 (5th Cir. 1973); *United States* v. *Deaton*, 381 F.2d 114, 117-18 (2d Cir. 1967) (citing cases). Although Chiarella did not contend he acted inadvertently, or through mistake, *see United States* v. *Semak*, 536 F.2d 1142, 1144-45 (6th Cir. 1976), the fact that he engaged in five separate transactions over a period of fifteen months would permit the jury to infer that his mind was focused on the nature of his acts, *see United States* v. *Catalano*, 491 F.2d 268, 275-76 (2d Cir.), *cert. denied*, 419 U.S. 825 (1974). In *United States* v. *Marcus*, 429 F.2d 654, 657-58 (3d Cir. 1970), relied on by Chiarella, the defendant was charged with knowingly attempting to pledge stolen securities. An instruction permitting the jury to infer knowledge that the securities were stolen from evidence

V.

Finally, Chiarella challenges a series of other rulings below, each of which he claims constituted reversible error. Only one of these contentions requires extended discussion.

Shortly after he was discharged by Pandick, appellant sought unemployment benefits from the New York State Department of Labor. In connection with the application, he signed a statement admitting that he was discharged for misusing confidential information and that "the allegation is true." When the Government subpoenaed the Labor Department file for use at trial, Chiarella moved to suppress the statement on the ground that it was privileged under N.Y. Labor Law § 537 (McKinney 1977). The statute provides that statements made in applying for unemployment benefits "shall not . . . be used in any court in any action or proceeding pending therein unless the commissioner [of labor] is a party to such action or proceeding."

We believe Judge Owen correctly denied the suppression motion and admitted the statement. State-created privileges[22] are not controlling in federal criminal cases

that defendant later sought to pledge other securities was held to be prejudicial error in the absence of proof that the latter securities were themselves stolen. *Id.* at 658. In short, the second attempt to pledge was not a "similar act," and *Marcus* is clearly distinguishable from the case before us. *See id.* at 658 n.3.

22 Chiarella contends that the Federal Unemployment Tax Act, 26 U.S.C. § 3304(a)(16), (17), providing for federal approval of state unemployment laws, transforms § 537 into an "Act of Congress" for purposes of Fed. R. Evid. 501. We are not inclined to read § 3304 so broadly because, as the Government has pointed out, the Secretary of Labor has approved unemployment laws in at least two states—Massachusetts and Washington—that specifically permit disclosure to prosecutors of statements such as Chiarella's. Mass. Ann. Laws ch. 151A, § 46 (Michie/Law. Coop. 1976); Wash. Rev. Code §§ 50.13.060, .070. In any event, this ground for excluding the statement was not raised below and is therefore waived. *E.g., United States* v. *Fuentes*, 563 F.2d 527, 531 (2d Cir.), *cert. denied*, 434 U.S. 959 (1977).

except to the extent they reflect "the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience," Fed. R. Evid. 501. *E.g., United States* v. *Craig*, 528 F.2d 773, 776 (majority), 781 (Tone, J., concurring on point), *aff'd en banc per curiam on panel concurrence*, 537 F.2d 957 (7th Cir.), *cert. denied*, 425 U.S. 973, 429 U.S. 999 (1976). To the extent § 537 does create a privilege under New York law, an issue we need not decide, it is one unknown to the common law. In view of the strong federal policy favoring admissibility in criminal cases, *see, e.g., United States* v. *Nixon*, 418 U.S. 683, 708-13 & n.18 (1974), the district court properly held the statement admissible. *See United States* v. *DiCarlo*, 565 F.2d 802, 806 (1st Cir. 1977), *cert. denied*, 98 S. Ct. 1487 (1978); *United States* v. *Schoenheinz*, 548 F.2d 1389 (9th Cir. 1977) (per curiam); *In re Grand Jury*, 541 F.2d 373, 378-83 (3d Cir. 1976); *Craig*, *supra*.

We have carefully considered appellant's remaining contentions and find them to be without merit. The judgment is affirmed.

MESKILL, *Circuit Judge*, dissenting:

I respectfully dissent. Today's decision expands § 10(b) drastically, it does so without clear indication in prior law that this is the next logical step on the path of judicial development of § 10(b), and, alarmingly, it does so in the context of a criminal case.

Nondisclosure Under § 10(b) and Rule 10b-5.

The majority holds that Chiarella committed a § 10(b) violation by breaking the "disclose or abstain" rule of *SEC* v. *Texas Gulf Sulphur*, 401 F.2d 833, 848 (2d Cir. 1968) *(en banc)*, *cert. denied*, 394 U.S. 976 (1969). However,

we have been cited no case in which even civil liability for nondisclosure has been imposed under § 10(b) on anyone other than an insider, the tippee of an insider, or one standing in a special relationship with other traders. More specifically, we have been cited no case in which *criminal* liability for § 10(b) nondisclosure has been imposed on *any* purchaser of stock, either insider *or* outsider. The majority terms "irrelevant" the fact that Chiarella was neither an insider of the companies whose securities he purchased, nor the tippee of an insider. Chiarella's location "inside the market itself" is today held to place him in a special relationship with all buyers and sellers with whom he might deal—a relationship which triggers the duty either to abstain or to disclose material nonpublic information. I am sympathetic to the majority's view that imposition of the duty to abstain or disclose on those who occupy strategic positions in the securities industry may further important goals embodied in the securities acts, such as maintaining investor confidence in the integrity of the market. However, we must resist the temptation to redraft legislation, in effect, by reading into it what we would like to see written there, especially where a criminal conviction is at issue.

That today's application of § 10(b) is a departure from prior law cannot be disputed.[1] In *General Time Corp.* v. *Talley Industries, Inc.*, 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969), this Court rejected a claim that a company acquiring stock in another corporation must disclose to selling shareholders plans for an eventual merger:

> We know of no rule of law, applicable at the time, that a purchaser of stock, who was not an "insider" and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale.

The Williams Act, not yet effective at the time of the transactions at issue in *General Time*, does impose disclosure obligations on certain large scale purchasers of stock, but it is conceded that Chiarella's trading was not covered by its provisions. *See* 15 U.S.C. §§ 78m(d), 78n(d).

As the commentators cited by the majority have observed, "[t]he duty to disclose material, non-public information has not been imposed on every person possessing this type of information. Traditionally, this obligation has been limited to persons with a special relationship *to the company affected by the information.*" Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. Pa. L. Rev. 798, 804 (1973) (emphasis added). *See also* Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the* Texas Gulf Sulphur *Proceeding*, 51 Va. L. Rev. 1271, 1280 (1965). Commentators on securities fraud law often discuss persons covered by the Rule 10b-5 disclosure duty without mention of traders other than insiders or tippees of insiders. *See, e.g.*, 1 A. Bromberg, Securities Law: Fraud, § 7.4(6)(b), at 179-83 (1977). Bromberg notes that judicial decisions have generally adopted the SEC's own view that anyone is subject to Rule 10b-5 disclosure obligations if he or she "has inside information obtained by reason of access to the issuer." *Id.* at 179.

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1 Indeed, this Court sitting *en banc* has stated that "to read Rule 10b-5 as placing an affirmative duty of disclosure on persons who in contrast to 'insiders' or broker-dealers did not occupy a special relationship to a seller or buyer of securities, would be occupying new ground and would require most careful consideration." *SEC* v. *Great American Industries, Inc.*, 407 F.2d 453, 460 (2d Cir. 1968) (*en banc*), *cert. denied*, 395 U.S. 920 (1969).

This access formula was first enunciated by the SEC itself in its leading decision of *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961):

> Analytically, the obligation [that is, the affirmative duty to disclose material information] rests on two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. *Thus our task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities.*

Id. at 912 (emphasis added). Eleven years after the *Cady, Roberts* decision this approach to Rule 10b-5 had become so firmly entrenched that this Court remarked: "The essential purpose of Rule 10b-5, as we have stated time and again, is to prevent corporate insiders and their tippees from taking unfair advantage of the uninformed outsiders." *Radiation Dynamics, Inc.* v. *Goldmuntz*, 464 F.2d 876, 890 (2d Cir. 1972).

The majority's break with this § 10(b) tradition is accomplished by the creation of the new category of "market insider," into which former outsiders will henceforth be placed. The majority sees in this new category a strong resemblance to the concept of the "quasi-insider" suggested in the comments accompanying the American Law Institute's *Federal Securities Code* (Proposed Official Draft, March 15, 1978). However, the proposed code quite clearly imposes an affirmative duty of disclosure *only* on insiders (explicitly defined in terms of their relationship with or access to the *issuer*) and tippees of insiders. The Reporter's comments indicate that the difficulties that would be posed by extending this duty to a wider range of traders were deemed to outweigh the "convenience" of such an extension. Thus, the drafters of the proposed Code respectfully rejected the position taken by the three concurring judges in *SEC* v. *Great American Industries, Inc.*, 407 F.2d 453 (2d Cir. 1968) *(en banc), cert. denied*, 395 U.S. 920 (1969), who expressed a willingness to catch non-insiders in the § 10(b) disclosure net. The ALI's proposed code, like prior law, explicitly recognizes that some cases of nondisclosure of material information by non-insiders, no matter how egregious, do not involve fraud and hence do not fall within the scope of § 10(b), the majority's statement to the contrary notwithstanding.[2]

Because § 10(b) and Rule 10b-5 apply to "any person," it is tempting to view limitations on the class of persons subject to an affirmative duty either to abstain or to disclose nonpublic information as overly technical barriers to the full pursuit of the goals of the federal securities laws. But § 10(b) prohibits fraud not silence. And it is hornbook law that silence, unlike active misrepresentation, is fraudulent only when there is a duty to speak.[3] Prosser,

2 *See* § 1603 and accompanying notes, particularly comment 3(d). American Law Institute, *Federal Securities Code* (Proposed Official Draft, March 15, 1978).

3 This case does not involve the prosecution of a "novel or atypical" type of fraud. *See, e.g., United States* v. *Brown*, 555 F.2d 336 (2d Cir. 1977); *A.T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (2d Cir. 1967). *Brown* and *Perlow* involved ingenious schemes which, while novel, were

Law of Torts § 106 (4th ed. 1971); 3 Loss, Securities Regulation, Chapter 9C (1961); 6 Loss, Securities Regulation, Chapter 9C (1969).

The majority suggests that the test of "regular access to market information" is a workable one for determining when such a duty is to be imposed on outsiders. *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972), a civil case, is the only precedent cited to buttress the majority's assertion that a "duty to disclose arising out of regular access to market information is not a stranger to the world of 10b-5." *Affiliated Ute* involved a bank which had agreed with the Ute Distribution Corporation (UDC) to act as transfer agent for its stock, which was being sold by its Indian owners to non-Indians. The bank itself had acknowledged in a letter to an association representing the Indian sellers that it would be the bank's " 'duty to see that these transfers were properly made' " and that " 'the bank would be acting for the individual stockholders.' " *Id.* at 152. Despite the access of the bank and its employees to market information which was not known to the sellers, the Supreme Court explained that if the bank "had functioned merely as a transfer agent, *there would have been no duty of disclosure here.*" *Id.* (emphasis added). It was because the defendants had devised a plan to induce the holders of the stock to sell and had developed and encouraged a market for their stock that defendants were held to have assumed an affirmative duty of disclosure. Thus,

clearly fraudulent under any definition of the term fraud. In contrast, Chiarella was prosecuted for trading without disclosing nonpublic, noninside information. Failure to make such disclosure is fraudulent only when a duty to disclose is violated. *See General Time Corp.* v. *Talley Industries, Inc.*, 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969) (permitting company to purchase target stock without disclosing plans for merger); *SEC* v. *Great American Industries, Inc.*, *supra*, 407 F.2d at 460.

it was not the bank's clearly superior, regular access to market information concerning UDC stock but its actions in undertaking to act for the sellers that rendered its silence equivalent to a scheme to defraud the selling shareholders. Chiarella certainly did not undertake to act for the sellers of the target stock, nor did he enter the type of special relationship with them which was determinative in *Affiliated Ute*.

The majority concedes, as it must, that the would-be tender offerors (also outsiders) from whom Chiarella derived his information may themselves purchase up to 5 percent of the target's stock without making any disclosure. *See* 15 U.S.C. §§ 78m(d), 78n(d); *General Time Corp.* v. *Talley Industries, Inc.*, *supra*, 403 F.2d 159. The majority distinguishes purchases by the offeror and purchases by Chiarella on the ground that the offeror takes an economic risk and Chiarella does not. We have been cited no case holding that the degree of risk assumed by a trader in possession of nonpublic information is determinative of the trader's liability for nondisclosure or renders his conduct fraudulent.

Chiarella has not been shown to have owed a duty of disclosure to the sellers of target stock. He owed a duty to the offeror corporation not to misuse confidential information entrusted to him. But the term "fraud" in Rule 10b-5 does not bring within the ambit of the rule "all breaches of fiduciary duty in connection with a securities transaction." *Santa Fe Industries* v. *Green*, 430 U.S. 462, 472 (1977). In most contexts, " 'fraud' still requires something more than 'unfairness' or breach of fiduciary duty." American Law Institute, *Federal Securities Code* (Proposed Official Draft, March 15, 1978) § 1603, Comment (3)(b).

Section 10(b) as a Criminal Statute.

If § 10(b) and Rule 10b-5 were broad enough to cover every securities-related maneuver that entailed unfairness or undermined investor confidence there would be no need for all the other statutes and rules that figure in the complex securities regulation scheme that Congress has been building since the 1930's. When a new weak point is identified—such as abuse of regular access to market information by certain participants in the industry—a direct attack on the problem through congressional legislation or SEC rulemaking would be a more appropriate response than the uncomfortable stretching of existing law engaged in by the majority here to cover the gap.[4] The SEC has been aware of the potential for abuse of nonpublic information by financial printers since at least 1971. *SEC* v. *Sorg Printing Co., Inc.*, C.C.H. Fed. Sec. L. Rep. ¶ 95,034 (S.D.N.Y. 1975). The SEC has sought and obtained several consent decrees enjoining the same conduct Chiarella engaged in

4 Because the question is not before us I express no opinion as to whether the SEC has been delegated the power to regulate printers engaged in securities work or whether congressional action is required. Either the legislative or the administrative process would make possible the imposition of trading restrictions responsive to the different possibilities for abuse of nonpublic information by outsiders as opposed to insiders. Contrary to the majority's statement, unfair advantage over other traders is not the only evil that insider trading restrictions are intended to avoid. The subtle infection of corporate decision-making by considerations of personal gain and other conflicts of interests inimical to the insider's duty to the corporation are also prevented by § 10(b) disclosure requirements, as well as by provisions like § 16 of the 1934 Act (regulating short swing profits). Study of the "market insider" problem and possible cures might yield a mechanism more precisely tailored to prevent the perceived evil without opening the door to those that the Court has not been given the opportunity to consider. For example, the impact, if any, of our decision on the practice of "warehousing" by tender offerors deserves thought. See, for discussion of warehousing, Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. Pa. L. Rev. 798, 811-815 (1973).

and ordering disgorgement of profits made in such transactions. *See, e.g., Sorg, supra; SEC* v. *Ayoub*, C.C.H. Fed. Sec. L. Rep. ¶ 95,567 (S.D.N.Y. 1976); *SEC* v. *Primar Typographers, Inc.*, C.C.H. Fed. Sec. L. Rep. ¶ 95,734 (S.D. N.Y. 1976). Apparently the government is of the view that imprisonment will succeed where other sanctions have failed. This may be. But whatever the wisdom of an extension of the "civil incarnation" of § 10(b) to cover the situation presented here, our lawmaking function is severely restricted in the criminal area. As the majority notes, we cannot uphold a conviction unless "a clear and definite statement of the conduct proscribed" antedates the actions alleged to be criminal. Chief Judge Kaufman in *United States* v. *Persky*, 520 F.2d 283, 287 (2d Cir. 1975), most perceptively identified the novel issue raised by the application of due process-vagueness-notice principles to § 10(b) criminal prosecutions.

> Perhaps the most interesting [issue] is the apparent dissonance between the general rule that criminal statutes are to be strictly construed in favor of the accused . . . and the realization that the civil incarnations of the anti-fraud provisions have, as remedial legislation, been openly and avowedly construed broadly.

(citations omitted).[5] In *Persky*, this same panel concluded that, as applied to Persky, it could not be said that "the

5 Compare the Supreme Court's cautious and restrictive interpretation of the Sherman Act in a recent criminal price fixing case in light of the fact that "the Act has not been interpreted as if it were primarily a criminal statute" but rather has been construed with great flexibility. *United States* v. *United States Gypsum Co.*, 46 U.S.L.W. 4937, 4942 (June 29, 1978). The same accommodation of criminal and remedial sanctions is necessitated by the structure and history of the securities acts. See also *United States* v. *Winston*, 558 F.2d 105, 109 (2d Cir. 1977), overturning a conviction under the Railway Labor Act: "The paucity of criminal proceedings under [45 U.S.C. § 152], when con-

expansive civil interpretations of Rule 10b-5 have so stretched the Rule that he was not provided fair warning that his conduct was fraudulent by the standard of strict construction due criminal statutes." *Id.* Persky, a securities lawyer and an officer of Microthermal Applications, Inc., engaged in a series of maneuvers, including filing false SEC reports, issuing misleading press releases, and making misrepresentations to Microthermal's shareholders, all calculated to cover up the president's misappropriation of company funds. Not only was Persky an insider owing a clear common law duty to the shareholders of his company, but his actions, designed to use his position of trust to further his own interests at the shareholders' expense, would fall within the most restrictive definition of "fraud." We specifically left open the possibility that § 10(b) might be unconstitutionally vague, in a criminal context, as applied to other behavior when we noted that Persky had no standing to challenge the law "on behalf of those whose conduct would be more ambiguous but who are not before us." *Id.* at 288.

I believe that the "clear and definite statement of the conduct proscribed" to which the majority concedes a defendant is entitled, must emanate from the language of the statute itself, from prior judicial interpretation, or from established custom and usage. Thus I fail to see the relevance to this issue of the warning signs posted by Pandick. While they *would* be most relevant to questions of willfulness, knowledge, or intent, signs posted by a private party

trasted with the active pursuit of civil relief thereunder, strongly supports appellants' contention that Congress intended criminal sanctions to apply only to the more egregious violations. Although the failure to enforce a statute over an extended period of time does not result in its repeal, . . . the 'gloss which life has written upon it' . . . indicates in this instance that strict construction of its terms is appropriate." (footnotes and citations omitted).

can hardly transform conduct otherwise not covered by a particular statute into conduct prohibited by that statute. Under our system only the legislature, not the private citizen, has this power.[6]

The majority has failed to uncover a sufficiently clear statement prohibiting Chiarella's actions to warrant imposition of a criminal sanction.[7] I wholeheartedly endorse the majority's explanation of the desirability and necessity of curbing the ability of those with access to nonpublic information to trade without making disclosure. And I recognize that as a civil, remedial statute § 10(b) has been and should be interpreted in a flexible fashion by the courts. Yet we cannot be deaf to recent caveats issued by the Supreme Court in slowing down the expansion of § 10(b) lest it take over "the whole corporate universe." *Santa Fe, Inc.* v. *Green, supra*, 430 U.S. at 480. We have been urged to turn first to the language of § 10(b) in ascertaining congressional intent. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976). We have been chided for relying on "the term 'fraud' in Rule 10b-5 to bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction" lest we add a gloss to the statute "'quite different from its commonly accepted meaning.'" *Santa Fe, Inc.* v. *Green, supra*, 430 U.S. at 472. The brakes have been applied in the context of private causes of action under § 10(b). Surely we should be even more fastidious

6 Nor would Chiarella's subjective view that his conduct was violative of the securities laws transform his actions, no matter how worthy of condemnation, into conduct criminal under §§ 10(b) and 32(a). *See United States* v. *Zacher*, slip op. 49, 58-59 (2d Cir. Oct. 17, 1978). For the same reason, civil consent decrees, entered into by parties who may want to avoid further litigation for any number of reasons, cannot transform behavior denounced by the SEC into criminal conduct.

7 As Chief Judge Kaufman has observed, the "exact nature and scope" of the federal law governing tippee trader liability "remain in a formative stage." *Schein* v. *Chasen*, 478 F.2d 817, 823 (2d Cir. 1973) (Kaufman, *J.*, dissenting), *vacated on other grounds*, 416 U.S. 386 (1974).

in our construction of the statute when we are asked to review a criminal conviction. Here, Chiarella was sentenced to a one year term of imprisonment, suspended except for one month, and a five year term of probation.

Conclusion.

Despite some dicta concerning the purpose behind the securities laws, *see, e.g., SEC* v. *Texas Gulf Sulphur Co., supra,* 401 F.2d at 847-48, "no case has held that there must be parity of material information between the parties to a securities transaction." Fleischer, Mundheim & Murphy, *supra,* 121 U. Pa. L. Rev. at 806. The disclosure duty has been imposed on insiders, broker-dealers, *Chasins* v. *Smith, Barney & Co.,* 438 F.2d 1167 (2d Cir. 1970), and those undertaking a special relationship with buyers or sellers of stock, *Affiliated Ute Citizens* v. *United States, supra,* 406 U.S. 128. "The problem in the silence cases is to identify the circumstances which trigger a duty to come forward with information." Fleischer, Mundheim & Murphy, *supra,* 121 U. Pa. L. Rev. at 803. To identify judicially a new triggering circumstance—regular receipt of market information—if appropriate at all, is not appropriate here. The criminal aspects of 10b-5 have been neither extensive nor significant prior to today. 3 Bromberg, *supra,* § 10.3 at 241. The ability of the SEC to function will not be severely hampered if it must await congressional action or action by its own rulemakers to correct any market distortion caused by wayward printers. As would any agency, the SEC would like to keep as many weapons in its arsenal as possible. But there are rules of combat, and our job is to see that the amenities are observed when the SEC embarks on a new crusade.

I would reverse the judgment of conviction and remand with instructions to dismiss the indictment.

APPENDIX B

UNITED STATES of America,

v.

Vincent CHIARELLA, Defendant.

No. 78 Cr. 2.

United States District Court,
S. D. New York.

March 29, 1978.

Defendant charged with criminal violation of statute prohibiting use of manipulative and deceptive devices in connection with sale or purchase of securities moved to dismiss indictment. The District Court, Owen, J., held that indictment which alleged that defendant, who was employed by financial printing house, received, in the course of his employment, materials from various corporations from which he learned of prospective tender offers, and that defendant then purchased for his own account shares of common stock of target companies without disclosing material, nonpublic information concerning tender offers, sufficiently alleged criminal violation of statute prohibiting use of manipulative and deceptive devices in connection with sale or purchase of securities; defendant's criminal liability was not contingent upon a finding that offering companies were similarly liable for pretender offer purchases of target companies' shares without disclosure of their intent.

Motion to dismiss denied.

Securities Regulation ⇐195

Indictment which alleged that defendant, who was employed by financial printing house, received, in the course of his employment, materials from various corporations from which he learned of prospective tender offers, and that defendant then purchased for his own account shares of common stock of target companies without disclosing material, nonpublic information concerning tender offers, sufficiently alleged criminal violation of statute prohibiting use of manipulative and deceptive devices in connection with sale or purchase of securities; defendant's criminal liability was not contingent upon a finding that offering companies were similarly liable for pretender offer purchases of target companies' shares without disclosure of their intent. Securities Exchange Act of 1934, §§ 10, 10(b), 15 U.S.C.A. §§ 78j, 78j(b).

Stanley S. Arkin, New York City, for movant Chiarella; Mark S. Arisohn, New York City, on the brief.

Robert B. Fiske, Jr., U. S. Atty., S. D. N. Y., by John S. Siffert, Asst. U. S. Atty., New York City, for the U. S.

1. Section 10 provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

and Rule 10b–5 thereunder, 17 C.F.R. § 240.10b–5,[2] moves for an order, pursuant to Fed.R.Cr.P. 12(b)(2), dismissing the indictment upon the ground that it fails to state an offense and, alternatively, for an order dismissing the indictment in the interest of justice.

The allegations of the indictment—taken as true for purposes of this motion—are essentially that between September 1975 and December 1976, Chiarella, a printer employed in the composing room of Pandick Press, Inc.,[3] in the course of his employment, received materials from various corporations to set in type. From these he would learn of prospective tender offers—presumably at prices above the market—by corporations for the stock of others or that a corporate merger was in prospect. He would then purchase for his own account shares of the common stock of the target companies without disclosing the material, non-public information he had thus learned. After each tender offer or proposed merger was announced, Chiarella would sell the shares in the target companies, at an aggregate profit of some $30,000. In all, the indictment alleges the use of such information on five different occasions.[4]

Chiarella claims that since the source of the information he failed to disclose was from outside the target corporations whose stock he purchased, he did not trade on "inside" information within the meaning of the securities laws. Further, he claims he was not in a fiduciary relationship as to anyone so that he had no duty of disclosure prior to purchasing shares in the target companies, and that, accordingly, his actions did not constitute even a civil violation of § 10(b)—and Rule 10b–5—much less a criminal violation.

The government, recognizing that this is a novel application of § 10(b), urges that under the law Chiarella could not trade in the shares of the target corporations at all. It contends that on the one hand, the federal securities laws required him to disclose the material, non-public information prior to trading, while on the other, the confidential nature of the information, by virtue of the purpose for which Pandick Press received it from the offering companies, precluded him from doing so.

Crediting the indictment, there is no question that Chiarella wrongfully took corporate information—unquestionably material and non-public—entrusted to him by offering corporations, and used it solely for personal profit, which information was "intended to be available only for a corporate purpose and not for the personal benefit of anyone . . . . ." *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961). The analogy of embezzlement by a bank employee immediately springs to mind, and, of course, embezzlement implies fraudulent conduct. *E. g., Grin v. Shine*, 187 U.S. 181, 189–90, 23 S.Ct. 98, 47 L.Ed. 130 (1902). Chiarella can, therefore, hardly claim that the acts alleged did not operate as a fraud. *See United States v. Persky*, 520 F.2d 283, 287–88 (2d Cir. 1975). Chiarella's purchases further acted as a fraud upon the acquiring corporations whose plans and information he took while he was setting them in type, because his purchases might possibly have raised the price of the target companies' stock, increasing the cost of legitimate market purchases by such acquiring corporations, and thus constituted "a manipulative or deceptive device or contrivance" within the prohibition of § 10(b) and Rule 10b–5. *See A. T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967).

Looking in the other direction, Chiarella's failure to disclose his purloined information to the sellers whose stock he purchased constituted an "inherent unfairness," *Cady, Roberts & Co., supra*, 40 S.E.C. at 912, and a "deceptive device" in connection with his purchases.

As to those from whom he purchased, however, Chiarella urges that he is criminally liable on these facts *only if* the offering companies are similarly liable for pretender offer purchases of target companies' shares without disclosure of their intent. The clear answer to this, as I perceive it, is that such corporate purchases have a presumptively legitimate business purpose to promote economic growth and are appropriately made without disclosure[5] so as not to "raise a seller's demands and thus abort the sale." *General Time Corp. v. Talley Industries, Inc.*, 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026, 89 S.Ct. 631, 21 L.Ed.2d 570 (1969). Chiarella's alleged misuse of information, in contrast, was solely for personal profit, serving no business purpose. It thus falls within the intent of Congress in the enactment of § 10(b) to punish "those manipulative and deceptive practices . . . [that] fulfill no useful function." S.Rep.No.792, 73d Cong., 2d Sess., 6 (1934).

The motion to dismiss is denied.

So Ordered.

2. Rule 10b–5 provides:

Employment of manipulative and deceptive devices.

It shall be unlawful for any reason, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

3. Pandick Press is a financial printing house that prints, among other things, tender offer materials for filing with the SEC and for distribution to shareholders.

4. Chiarella's use of the mails in furtherance of his purchases satisfies the statutory requirement of § 10 for federal jurisdiction.

5. Subject to the requirements of the Williams Act, §§ 13(d) & 14(d) of the Securities Ex-

APPENDIX C

Appendix C

Constitutional Provisions, Statutes and Regulations Involved

Constitutional Provisions:

Constitution of the United States, Amendment 5

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

Statutes:

15 U.S.C. §78j(b)

§78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or unstrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

§15 U.S.C. §78ff

§78ff. Penalties

(a) Any person who willfully violates any provision of this chapter (other than section 78dd-1 of this title), or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than $10,000, or imprisoned not more than five years, or both, except that when such person is an exchange, a fine not exceeding $500,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

Rule 501, Federal Rules of Evidence

Except as otherwise required by the Constitution of the United States or provided by Act of Congress or in rules prescribed by the Supreme Court pursuant to statutory authority, the privilege of a witness, person, government, State, or political subdivision thereof shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience. However, in civil actions and proceedings, with respect to an element of a claim or defense as to which State law supplies the rule of decision, the privilege of a witness, person, government, State, or political subdivision thereof shall be determined in accordance with State law.

New York Labor Law, §537

§537. Disclosures prohibited

1. Use of information. Information acquired from employers or employees pursuant to this Article shall be for the exclusive use and information of the commissioner in the discharge of his duties hereunder and shall not be open to the public nor be used in any court in any action or proceeding pending therein unless the commissioner is a party to such action or proceeding, not withstanding any other provisions of law. Such information insofar as it is material to the making and determination of a claim for benefits shall be available to the parties affected and, in the commissioner's discretion, may be made available to the parties affected in connection with effecting placement.

2. Penalties. Any officer or employee of the state, who, without authority of the commissioner or as otherwise required by law, shall disclose such information shall be guilty of a misdemeanor.

Regulations:

17 C.F.R. §240.10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or

(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Supreme Court, U. S.
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No. 78-1202

In the Supreme Court of the United States

OCTOBER TERM, 1978

VINCENT F. CHIARELLA, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINIONS BELOW

The opinion of the court of appeals is reported at 588 F. 2d 1358 (Pet. App. A1-A34). The opinion of the district court is reported at 450 F. Supp. 95 (Pet. App. B1-B3).

JURISDICTION

The judgment of the court of appeals was entered on November 29, 1978. A petition for rehearing was denied on January 4, 1979. The petition for a writ of certiorari was filed on February 2, 1979. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether petitioner's purchase of securities based on material non-public information concerning forthcoming corporate acquisitions, obtained through his employment

in a financial printing firm, violated Section 10(b) of the Securities Exchange Act of 1934.

2. Whether Section 10(b) provided fair notice that petitioner's conduct was prohibited.

3. Whether the district court's instructions on intent were correct.

4. Whether the district court properly received in evidence an admission by petitioner that was privileged under state, but not federal, law.

STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT

After a jury trial in the United States District Court for the Southern District of New York, petitioner was convicted on 17 counts of securities fraud, in violation of 15 U.S.C. 78j(b), 17 C.F.R. 240.10b-5, and 18 U.S.C. 2. He received concurrent sentences of one year's imprisonment on the first 13 counts, of which all but one month was suspended. Sentences were also suspended on the last four counts, and petitioner was placed on five years' probation. The court of appeals affirmed (Pet. App. A1-A34).

The evidence at trial, which is summarized in the opinion of the court of appeals (Pet. App. A2-A5), showed that petitioner was an employee in a financial printing firm in New York City that specialized in printing prospectuses and other documents used in the securities industry. Because of the importance and confidentiality of the information contained in those documents and the statutory prohibition against misuse of that information, the printing firm gave express warning to its employees by signs placed throughout the establishment that such information was not to be used by any employee for private benefit, and that violation of this rule would subject the employee to immediate discharge and criminal penalties (Pet. App. A16-A17).

Between September 1975 and November 1976, petitioner's firm printed confidential documents relating to four tender offers and one merger. To preserve strict confidentiality, those documents were initially printed with the identities of the target corporations either omitted or expressed in code. In violation of the rules of his firm, petitioner used information contained in the draft offering documents (such as the market on which the stock was traded, the number of shares outstanding, the par value of the stock, and the high and low bids for the preceding year) to determine the identities of the five companies that were being acquired.[1] He then purchased stock in each corporation through seventeen separate transactions. After the merger and tender offers were publicly announced, the market price of the stocks increased substantially. In each instance, petitioner promptly sold the shares that he had purchased, making a profit totalling over $30,000.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review by this Court is unwarranted.

1. Petitioner argues (Pet. 4) that his conviction was based on an unprecedented interpretation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. He further contends that liability has never before been imposed on anyone trading on the basis of material non-public information stemming from sources outside the corporation that issued the securities purchased or sold. That contention misconceives the purpose of the antifraud provisions in question and ignores prior precedent applying them in analogous situations.

[1]This information was stipulated to be "material" in nature (Pet. App. A5 n.5).

A prime concern of Congress in enacting the Securities Exchange Act of 1934 was to preserve "fair and honest markets" essential to the confidence of public investors. See Section 2 of the Act, 15 U.S.C. 78b. See also *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 195 (1976); *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 11-12 (1971). To that end, Congress included the general antifraud provision of Section 10(b) as a "catch-all" to prohibit the use by any person of any manipulative or deceptive device or contrivance in connection with a purchase or sale of securities. This broad antifraud provision was intended " 'to deal with new manipulative [or cunning] devices' " injurious to the statutory goal of fair and honest trading (*Ernst & Ernst* v. *Hochfelder, supra*, 425 U.S. at 203 (brackets in original)), particularly those "practices which have been demonstrated to fulfill no useful function" (S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934)). As this Court has repeatedly noted, one of the fundamental purposes of Section 10(b) is to assure that "a high standard of business ethics [prevails] in the securities industry." *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972).[2]

Section 10(b) and Rule 10b-5 have long been interpreted to protect "the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information." *SEC* v. *Texas Gulf Sulphur Co.*, 401 F. 2d 833, 847-848 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). Accord, *SEC* v. *Shapiro*, 349 F. Supp.

[2]Congress reaffirmed these goals in 1975 when it adopted certain amendments to the Securities Exchange Act:

> The basic goals of the Exchange Act remain salutatory and unchallenged: To provide fair and honest mechanisms for the pricing of securities, to assure that dealing in securities is fair and without undue preferences or advantages among investors * * * and to provide, to the maximum degree practicable, markets that are open and orderly.

H.R. Conf. Rep. No. 94-229, 94th Cong., 1st Sess. 91-92 (1975).

46, 52-53 (S.D.N.Y. 1972), aff'd, 494 F. 2d 1301 (2d Cir. 1974). The use of material non-public information, whether it is characterized as market information or corporate information, to obtain a trading advantage over other public investors is injurious to public confidence in the securities markets. This is especially true in the case of persons in the position of petitioner, since, as the court of appeals noted, "Chiarella had access on a regular basis to the most confidential information in the world of finance. Five times in less than fifteen months he obtained knowledge of facts that, when released, would have an immediate and dramatic effect 'on the Street' " (Pet. App. A7).

Because material information useful in securities trading generally stems from corporations that issue securities, most of the cases dealing with misuse of non-public information have involved inside corporate information. But even cases arising in that context have been careful to note that the rule against misuse of non-public information is not limited to such circumstances. Thus, in the seminal case of *In re Cady, Roberts & Co.*, 40 S.E.C 907 (1961), upon which petitioner relies, the Commission pointed out that "corporate insiders, e.g., officers, directors and controlling stockholders * * * do not exhaust the classes of persons upon whom there is such an obligation [to refrain from trading when in possession of material confidential information]." 40 S.E.C. at 912. The Commission there noted that the respondent had abused a confidential relationship by trading on inside information and had taken advantage of other persons participating in the market who lacked the benefit of such information. *Ibid.*

It is well settled that Section 10(b) and Rule 10b-5 are intended to protect public investors, and are not merely devices to safeguard the confidential relationship between insiders and issuer corporations. Thus, in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 150-154 (1972), this Court held that persons who profit by making a

market in a security may not effect transactions on behalf of others without disclosing to them the facts relevant to market conditions. The defendants in *Ute*, like petitioner, misused non-public market information obtained by virtue of their relationship to the market for the securities in which they traded. The non-public information in *Ute* did not stem from a confidential corporate source, nor was it "inside" information in the traditional sense. This Court nonetheless held that Section 10(b) and Rule 10b-5 prohibited the defendants from exploiting their special knowledge of market conditions to the detriment of security sellers.[3]

Moreover, there is little difference between petitioner's conduct and that condemned in *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180 (1963), a case arising under Section 206 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6), an antifraud provision containing prohibitions comparable to those of Rule 10b-5. In that case, an investment adviser purchased securities, made recommendations to his clients to purchase those same securities, and sold his shares thereafter when their market price had risen as a result of his recommendations. The defendant in *Capital Gains*, like petitioner, was trading on the basis of undisclosed market information, not information stemming from the corporation that issued the securities that he purchased. See also *SEC* v. *Shapiro*, 494 F. 2d 1301 (2d Cir. 1974), holding that Rule 10b-5 prohibits financial consultants from using non-public information concerning a merger plan of one corporation to purchase for themselves the securities of the other corporation involved in the merger. Petitioner's

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[3]See also *In re Blyth & Co., Inc. and Briggs*, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 77,647 (SEC 1969).

position with respect to the company whose shares he purchased is not logically distinguishable from that of the financial consultants in *Shapiro*.[4]

Petitioner nonetheless contends (Pet. 9) that because parties seeking control of corporations may make limited purchases before disclosing their acquisition plans, he was also entitled to make purchases without infringing Section 10(b) and Rule 10b-5. However, acquiring parties are expressly permitted, pursuant to Section 13(d) of the Securities Exchange Act, 15 U.S.C. 78m(d), to purchase up to five percent of any class of equity securities of the acquired company without filing a disclosure statement. And Section 14(d) of the Act, 15 U.S.C. 78n(d), provides that a disclosure statement regarding a tender offer need not be filed until the offer is first published or sent to security holders. Those provisions reflect the congressional intent to strike a balance between the goals of full disclosure and the secrecy that must be maintained if legitimate corporate acquisitions are to take place. See generally H.R. Rep. No. 1711, 90th Cong., 2d Sess. 4 (1968). Thus, the statute explicitly allows potential tender offerors to "test the market" by confidentially acquiring limited quantities of the target company's stock.

This special rule, applicable to acquiring parties, has no relevance to petitioner's case. Petitioner was not engaged in the kind of legitimate economic activity that necessitates limited trading without disclosure of the trader's business plans. To the contrary, petitioner converted confidential information belonging to another

[4]If petitioner were correct in contending that Section 10(b) prohibits misuse only of information stemming from issuer corporations, then it would follow that Section 10(b) permits officers and agents of acquiring firms to purchase the securities of target firms based on their knowledge of forthcoming mergers, acquisitions, and tender offers. That would clearly be contrary to the statutory purpose to preserve open and honest securities markets without preferences and advantages among investors.

party for the sole purpose of obtaining an advantage over uninformed sellers trading in the securities marketplace. As the court of appeals noted, "[i]t is difficult to imagine conduct less useful, or more destructive of public confidence in the integrity of our securities markets" (Pet. App. A15).

2. Petitioner also contends (Pet. 15-20) that his prosecution infringed the Due Process Clause because he had no fair warning that Section 10(b) and Rule 10b-5 would apply to his conduct. But all of the legal principles discussed immediately above were well established long before petitioner undertook his scheme to misuse non-public information. Moreover, those principles had been applied to misuse of tender offer information by employees of printing firms prior to the time of petitioner's purchases. See *SEC* v. *Sorg Printing Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 95,034 (S.D.N.Y. 1975). And, as noted by the court of appeals (Pet. App. A16-A17), petitioner received specific warnings from his employer that use of confidential information for securities trading would result in criminal penalties. The court below was therefore correct in concluding that petitioner "manifestly had adequate notice that his trading in target stock could subject him to criminal liability" (Pet. App. A15).[5]

[5]Even if the prior proceeding in the *Sorg* case had not established that Rule 10b-5 applies to misuse of non-public information by print shop workers, that would not stand in the way of the present prosecution. Where a willful violation of the securities laws occurs, it is irrelevant that a case presenting precisely the same factual pattern has not arisen before. See *United States* v. *Brown*, 555 F. 2d 336, 339-340 (2d Cir. 1977) (the "fact that there is no prior litigated fact pattern precisely in point may constitute a tribute to the cupidity and ingenuity of the malefactors involved but hardly provides an escape from the penal sanctions of the securities fraud provisions here involved").

3. Petitioner also contends (Pet. 21-22) that the district court erred in refusing to instruct the jury that it must find a specific intent to defraud before convicting him.

But, as the court below noted, the district court instructed the jury that petitioner could not be convicted unless he acted "knowingly and willfully," with "a realization * * * that he was doing a wrongful act * * * and that the knowingly wrongful act involved a significant risk of effecting the violation that occurred" (Pet. App. A17-A18). Petitioner concedes that the court's instructions fully complied with the requirements of Section 32(a) of the Act, 15 U.S.C. 78ff(a), the general provision authorizing criminal prosecutions. See, *e.g.*, *United States* v. *Peltz*, 433 F. 2d 48, 53-54 (2d Cir. 1970), cert. denied, 401 U.S. 955 (1971). He asserts, however, that *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), invalidates the charge. But the holding in *Hochfelder* was that "§ 10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone" (*id.* at 201). In distinguishing between mere negligence and conduct involving some element of scienter, the Court obviously cannot be read as having suggested that knowing and willful misconduct is beyond the scope of the statute.

4. Finally, petitioner contends (Pet. 22-25) that the district court erred in allowing into evidence his admission to the New York State Department of Labor that he was fired for violating his company's rule prohibiting private use of confidential client information because such admissions are privileged under state law. As the court of appeals noted, however, even if the statement was privileged under state law, "[s]tate-created privileges are not controlling in federal criminal cases except to the extent they reflect 'the principles of the common law as they may be interpreted by the courts of the United States

in the light of reason and experience' " (Pet. App. A22-A23). That analysis complies fully with Fed. R. Evid. 501. See also *Funk* v. *United States*, 290 U.S. 371 (1933); *United States* v. *Allery*, 526 F. 2d 1362, 1364 (8th Cir. 1975). See generally, *United States* v. *Nixon*, 418 U.S. 683, 708-713 & n.18 (1974). Accordingly, the district court was not bound to recognize the New York privilege.

In any event, even if the admission of petitioner's statement was in error, any such error was clearly harmless. The evidence overwhelmingly established that petitioner was aware of his company's rule. As the court of appeals pointed out, signs warning petitioner of the company's rule were posted throughout the plant, and petitioner admitted passing those signs on hundreds of occasions. The district court concluded that his assertion that he had not read these signs was perjury "beyond a reasonable doubt" (Pet. App. A17 n.18). In light of the clear evidence of *mens rea*, the admission of cumulative evidence on this point could not have affected the result.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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IN THE

Supreme Court of the United States

October Term, 1978

No. 78-1202

VINCENT F. CHIARELLA,

Petitioner,

against

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR THE PETITIONER

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IN THE

Supreme Court of the United States

October Term, 1978

No. 78-1202

VINCENT F. CHIARELLA,

Petitioner,

against

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR THE PETITIONER

Opinions Below

The opinion of the United States Court of Appeals for the Second Circuit (Appendix A to Chiarella's petition for a writ of certiorari) is reported at 588 F.2d 1358. The opinion of the United States District Court for the Southern District of New York (Appendix B to Chiarella's petition for a writ of certiorari) is reported at 450 F.Supp. 95.

Jurisdiction

The judgment of the Court of Appeals for the Second Circuit was entered November 29, 1978. A motion for rehearing with a suggestion for rehearing *en banc* was denied by the Court of Appeals on January 4, 1979. The petition for a writ of certiorari was filed on February 2, 1979 and was granted on May 14, 1979. The jurisdiction of this Court rests on 28 U.S.C. §1254(1).

Constitutional Provisions, Statutes and Rules Involved

Constitutional Provisions:

Constitution of the United States, Amendment 5

> No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment of indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

Statutes:

15 U.S.C. §78j(b) (Section 10[b] of the Securities Exchange Act of 1934):

§78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality

of interstate commerce or of the mails, or of any facility of any national securities exchange

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

§15 U.S.C. §78ff(a) (Section 32[a] of the Securities Exchange Act of 1934):

§78ff. Penalties

(a) Any person who willfully violates any provision of this chapter (other than Section 78dd-1 of this title), or any rule or regulation thereunder, the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of Section 78o of this title or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than $10,000, or imprisoned not more than five years, or both, except that when such person is an exchange, a fine not exceeding $500,000 may be imposed; but no person shall be subject to imprisonment under this Section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

Rule 501, Federal Rules of Evidence:

Except as otherwise required by the Constitution of the United States or provided by Act of Congress or in rules prescribed by the Supreme Court pursuant to statutory authority, the privilege of a witness, person, government, State, or political subdivision thereof shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience. However, in civil actions and proceedings, with respect to an element of a claim or defense as to which State law supplies the rule of decision, the privilege of a witness, person, government, State, or political subdivision thereof shall be determined in accordance with State law.

New York Labor Law, §537:

§537. Disclosures prohibited

1. Use of information. Information acquired from employers or employees pursuant to this Article shall be for the exclusive use and information of the commissioner in the discharge of his duties hereunder and shall not be open to the public nor be used in any court in any action or proceeding pending therein unless the commissioner is a party to such action or proceeding, notwithstanding any other provisions of law. Such information insofar as it is material to the making and determination of a claim for benefits shall be available to the parties affected and, in the commissioner's discretion, may be made available to the parties affected in connection with effecting placement.

2. Penalties. Any officer or employee of the state, who, without authority of the commissioner or as otherwise required by law, shall disclose such information shall be guilty of a misdemeanor.

Regulations:

17 C.F.R. §240.10b-5 (Rule 10b-5):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or

(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Questions Presented for Review

1. Does the purchaser of stock in the open market who fails to disclose material, nonpublic information about the issuer of the stock violate Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 where the purchaser has no fiduciary relationship with the issuer and where the information was obtained from and created by a source wholly outside and unrelated to the issuer?

2. Does the Second Circuit's retroactive application of its new and expansive interpretation of Section 10(b) and Rule 10b-5 to sustain petitioner's conviction violate the Due Process Clause of the Fifth Amendment?

3. In a criminal case charging violations of Section 10(b) and Rule 10b-5, did the trial court violate this Court's holding in *Ernst & Ernst* v. *Hochfelder* by refusing to instruct the jury that "intent to defraud" was a requisite element of the crime?

4. Did the trial court err in admitting into evidence at petitioner's federal criminal trial a confidential statement—in this case tantamount to a confession—required to be made by petitioner to the New York State Department of Labor as a condition of seeking unemployment benefits when New York law makes the statement absolutely privileged from disclosure and makes disclosure of that statement a criminal act?

Statement of the Case

Vincent F. Chiarella was employed as a "mark-up" man in the composing room at Pandick Press, a financial printing company in New York City (R.182-83, 234-35).[1] During the course of his employment in 1975 and 1976, Chiarella worked on setting into type prospectuses and other documents for corporate customers of Pandick who were about to announce take-over bids (tender offers) for other companies (R.283-84). Pandick's customers, the prospective tender offerors, provided the textual material to be printed to Pandick, but particular information as to the identity of the corporation proposed for take-over (the target) was encoded or simply left blank (R.222-23, 228).

1. References in parentheses preceded by "R." are to pages of the original record of the proceedings in the District Court. On June 11, 1979, this Court granted Chiarella's motion to dispense with printing an appendix and for leave to proceed on the original record.

In each case relevant here Chiarella was able to deduce the identity of the takeover candidate (target) from data which was disclosed in the material provided for printing by the prospective offeror corporations (R.474). Then, prior to public announcement of the take-over bids or tender offers, Chiarella purchased shares of the corporation he believed was the target (R.474-78).

Chiarella successfully determined the identity of five companies targeted for take-over by customers of Pandick Press. His 17 separate purchases of target shares, prior to public announcement of the tender offers and sale of those shares after news of the tender offers became public, netted Chiarella a $30,000 profit (GX6, 7, 10, 61).[2]

Since each of Chiarella's stock purchases was transacted through his broker over the open market, Chiarella never met nor had any dealings whatever with the target corporation shareholders whose stock he acquired (R.482). And Chiarella specifically denied that he intended to defraud anyone in connection with his stock purchases (R.483-84).

Prior to Chiarella's stock transactions, Pandick Press had posted a sign (GX14A) warning its employees that it was violative of company policy for any employee to utilize information learned from a customer's copy for his own benefit and that such conduct would result in the employee's termination from employment and could result in criminal penalties. Although Chiarella was aware that his conduct violated Pandick's rules, he did not believe that his actions were unlawful (R.491). Having set the type of hundreds

2. Numerical references in parentheses preceded by "GX" refer to government exhibits in evidence.

of tender offer prospectuses which reveal the details of all pre-announcement trading in target shares by tender offerors, Chiarella was well aware that it was the common practice of prospective tender offerors to purchase target shares on the open market prior to announcement of their tender offer plans (GX31F, R.489-92).[3] Chiarella explained what his knowledge of the practice of offeror corporations meant to him (R.492):

> "I was doing the same thing that they were doing and I had no intention of doing anything wrong with that."

An investigation by the SEC into trading activity in one of the target corporations whose shares Chiarella purchased led to the commencement of an injunctive action by the SEC against Chiarella (*SEC* v. *Chiarella,* No. 77 Civ. 2534 [S.D.N.Y. 1977]). The SEC proceeding was settled when Chiarella entered into a consent decree with the SEC and disgorged his $30,000 profit to those target shareholders whose stock he fortuitously purchased (R. 15-17).

Shortly thereafter Chiarella was fired by Pandick and sought unemployment insurance benefits (R.484-85). In

3. The common practice of a prospective offeror purchasing shares of the prospective target in the open market is demonstrated by one of the proofs Chiarella is alleged to have worked on. Government Exhibit 31F—the printer's proof which underlies Counts 11 and 12—establishes that three weeks prior to the announcement of the tender offer, the offeror had purchased on the open market 34,000 shares of the target corporation's stock. The document contains the following language:

> "Neither the Offeror, any officer or director of the Offeror, nor any affiliated person has effected any transaction in the Shares during the past 60 days *except for the purchase in brokerage transactions by the Offeror during the period from September 7, 1976, through September 17, 1976 of an aggregate of 34,000 shares.* . . ." (Emphasis supplied.)

the process of seeking those benefits, Chiarella met with a New York State unemployment examiner who told Chiarella to explain the reasons for having been fired. Chiarella gave the examiner the full statement of reasons requested (R.275-78).

In January, 1978, Chiarella was indicted on 17 counts (each count representing a separate purchase of target stock) charging violations of Section 10(b) and Rule 10b-5. A pre-trial motion to dismiss the indictment upon the ground that the conduct alleged—the purchase of stock without disclosure of material, nonpublic information—was not within the scope of Section 10(b) and Rule 10b-5 because Chiarella had no relationship with the target corporations and was under no duty to disclose his information which originated with the offeror corporations, was denied in a written opinion (*United States* v. *Chiarella,* 450 F.Supp. 95 [S.D.N.Y. 1978]; Appendix B to Chiarella's petition for a writ of certiorari).

At trial in the Southern District of New York before the Honorable Richard Owen and a jury, Chiarella objected unsuccessfully to the introduction into evidence of the statements he made in connection with seeking unemployment benefits (GX12; transcript of proceedings April 3, 1978, pp. 1-24 — 1-34; transcript of proceedings April 4, 1978, pp. 152-154; R.275). His requests to charge the jury that specific intent to defraud was a requisite element of the crime were denied (R.559-60, 572-73, 712).

On April 10, 1978, Chiarella was convicted on all counts (R.723) and on May 19, 1978 he was sentenced to a term of imprisonment of one year with all but one month suspended on each of counts 1-13 to run concurrently and to

a term of probation of five years on counts 14-17 (see judgment filed May 19, 1978).

Chiarella's conviction was affirmed by the United States Court of Appeals for the Second Circuit on November 29, 1978 by a divided panel (Kaufman, Ch. J. and Smith, J.; Meskill, J. dissenting). A motion for rehearing and suggestion for rehearing *en banc* was denied on January 4, 1979.

Pending this Court's decision, Chiarella's sentence has been stayed. Bail in the form of a $10,000 personal recognizance bond was posted.

Summary of Argument

I. Chiarella's conduct is not within the scope of Section 10(b) and Rule 10b-5. Nothing in the plain language of the statute and rule suggests liability for trading without disclosure of material, nonpublic information. The legislative history of the statute shows that Chiarella's conduct was never intended by congress to be covered by Section 10(b). The administrative history and administrative and judicial interpretations of the Rule show its application to nondisclosure of material nonpublic information has been grounded in the trader's breach of a duty to disclose arising out of a fiduciary or other special relationship with the issuer corporation—a relationship Chiarella concededly did not have. Indeed, conduct identical to Chiarella's—an "outsider's" purchase of an issuer's stock based on and without disclosure of an impending tender offer for the issuer's shares—has specifically been ruled out as a *civil* violation of Rule 10b-5 by every court

that has addressed the issue. Moreover, an expansive interpretation of Section 10(b) and Rule 10b-5 conflicts with the required strict construction of criminal statutes.

II. The fair notice requirement of the Due Process Clause was violated by Chiarella's conviction. The state of the law—prior judicial interpretations, administrative actions and rulings, legislative history, other relevant statutory provisions, as well as custom and usage—was such at the time of his security transactions that no one could have rationally predicted that Chiarella's conduct would come within Section 10(b) and Rule 10b-5. The Second Circuit's novel and expansive interpretation of the law and rule to cover Chiarella's conduct by the creation of a new "test" for liability—"regular access to market information"—is, much like an *ex post facto* law, constitutionally impermissible.

III. The trial court's refusal to charge the jury that "specific intent to defraud" was an essential element of the crimes charged violated this Court's holding in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976). The charge given, that Chiarella could be convicted if the jury found he had a realization that his conduct was wrongful, was not sufficient to charge the very different concept of specific intent to defraud required by *Hochfelder*.

IV. The statements made by Chiarella to New York's Department of Labor and later used against him at his trial should not have been admitted into evidence. The New York law makes the statements absolutely privileged from disclosure, prohibits their use in any court, and punishes disclosure as a criminal offense. This privilege and

rule of inadmissibility should have been sustained in Chiarella's federal criminal trial under Rule 501 of the Federal Rules of Evidence. Honoring the privilege in federal court is consistent with federal interests. Congressional enactments have evinced a clear intent to protect information required by federal as well as state agencies. Constitutional considerations, founded on the Fifth Amendment right against self-incrimination, also favor recognition of the privileged status of this information. In addition, this Court has approved a specific rule which would have required federal courts to defer to the state privilege which attached to Chiarella's statement.

ARGUMENT

POINT I

The purchase of stock on the open market based on and without disclosure of material, nonpublic information does not violate Section 10(b) of the 1934 Securities Exchange Act and Rule 10b-5 promulgated thereunder where the purchaser has no fiduciary or other special relationship with the issuer or its stockholders and the information was obtained from and created by a source wholly outside and unrelated to the issuer.

A. Introduction

This case is the first criminal prosecution ever brought under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 for securities trading based on and without disclosure of material, nonpublic information. Not even a true corporate "insider" (which Chiarella is not) who traded on "inside" information obtained from

the issuer corporation (which Chiarella did not) has ever been charged with a crime under Section 10(b) and Rule 10b-5. Nor has there ever been a litigation in which even civil liability for nondisclosure has been imposed under Section 10(b) and Rule 10b-5 on someone like Chiarella who concededly is not an "insider," the "tippee" of an "insider," or one with a special relationship with other traders and investors.

Nothing in the language or history of Section 10(b) and Rule 10b-5 supports the expansion of the statute and rule to embrace the conduct at issue here. Indeed, conduct identical to Chiarella's—an "outsider's" purchase of an issuer's stock based on and without disclosure of an impending tender offer for the issuer's shares—has specifically been ruled out as a civil breach of Section 10(b) and Rule 10b-5 by every court that has addressed the issue. Moreover, the expansive view of the statute and rule urged by the government in support of this criminal case and adopted by the courts below to uphold the indictment and affirm the conviction flatly conflicts with the fundamental rule requiring strict construction of penal laws.

B. The Language and History of Section 10(b) and Rule 10b-5

Mr. Justice Rehnquist noted in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 737 (1975), that the case law which has developed under Section 10(b) of the 1934 Securities Exchange Act is tantamount to "a judicial oak which has grown from little more than a legislative acorn." The metaphor is particularly apt in this case because analysis of the language and history of the statute and Rule

10b-5 promulgated by the SEC pursuant to the statute shows that the genetic makeup of the "acorn" is inconsistent with what the government urges should be a new branch on the "judicial oak"—criminal liability for mere silence by a non-insider in connection with a stock transaction.

1. The Language of the Statute and Rule

The language of Section 10(b) and Rule 10b-5 does not proscribe trading without disclosure of material, nonpublic information. Section 10(b) makes unlawful "in connection with the purchase or sale" of securities the "use or employ[ment]" of "any manipulative or deceptive device or contrivance" in contravention of SEC rules. SEC's Rule 10b-5 prohibits in connection with the purchase or sale of securities (1) the "employ[ment of] any device, scheme, or artifice to defraud," (2) the "mak[ing of] any untrue statement of a material fact" or the "omi[ssion] to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading," and (3) the "engag[ing] in any act, practice or course of business which operates or would operate as a fraud or deceit."

The only nondisclosure specifically addressed is the failure to reveal "a material fact" necessary to make other statements made not misleading. Thus, affirmative misrepresentation by the device of half-truths is plainly prohibited by the language of Rule 10b-5. Total silence in connection with a stock transaction—the conduct at issue here—is not referred to at all.[4] Indeed, since the "scope [of SEC Rule 10b-5] cannot exceed the power granted the Commission by Congress under §10(b)" which proscribes only "manipulative or deceptive device[s] or contrivance[s]," the general fraud prohibitions of clauses 1 and 3 of Rule 10b-5 (employing a "device, scheme, or artifice to defraud" and engaging in an "act, practice or course of business which operates . . . as a fraud or deceit") cannot be construed to make unlawful *every* failure to disclose material, nonpublic information (*Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214 [1976]). At most, only a failure to disclose that amounts to a "manipulative or deceptive device or contrivance" is within the plain meaning of Section 10(b) and Rule 10b-5.

2. Legislative History of Section 10(b)

Nothing in the legislative history of Section 10(b) reveals a congressional intent to include trading without disclosure of material, nonpublic information within the concept of "manipulative or deceptive device or contrivance." Congressional concern was with prohibiting manipulative and deceptive devices in connection with stock transactions which had the danger of artificially and dishonestly affecting the market price of securities. The language now comprising Section 10(b) was originally included as Section 9(c) of the bills introduced in the Senate and House (S. 2693, 73d Cong. 2d Sess. [1934]; H.R.

4. In recognition of the plain meaning of clause 2 of Rule 10b-5, the district court dismissed that portion of the indictment charging Chiarella with having omitted to state a material fact necessary in order to make the statements made not misleading (R.537, 550). Since Chiarella made no statement at all in connection with his stock purchases, there was no evidence to support the charge that he violated clause 2 of Rule 10b-5.

7852, 73d Cong. 2d Sess. [1934]; H.R. 8720, 73d Cong. 2d Sess. [1934]). The other subsections of Section 9 authorized the SEC to regulate securities transactions involving "short" sales and "stop-loss" orders—practices which could create a false or misleading appearance of trading activity and have an effect on market prices not reflective of true market conditions. The committee hearings regarding Section 9(c)'s prohibition on the use of "any manipulative or deceptive device or contrivance" reveal that the subsection was designed as a catch-all to insure that other types of manipulation or deception resulting in the generation of artificial prices not specifically prohibited by the express provisions of Section 9 would be prohibited through appropriate SEC regulation. *See* Hearings on Stock Exchange Regulations Before the House Committee on Interstate and Foreign Commerce, 73d Cong. 2d Sess. 115 (1934).[5] Trading on material, nonpublic information, a practice which would tend to push the market price of a security in the right direction, is not within the ambit of congress' intention to regulate "manipulative or deceptive device[s] or contrivance[s]" which could

5. There is evidence in the legislative history that congress assumed that problems regarding trading without disclosure of material, nonpublic information were distinct from problems of manipulation and deception. Congress chose to deal with the problem of "insider" trading explicitly in Section 16(b) (15 U.S.C. §78p[b]) by providing for corporate recovery of short swing profits made on transactions by "insiders." There is no suggestion anywhere in the legislative history of the 1934 Act that congress intended any other section to deal with the subject. *See*, S. Rep. No. 792, 73rd Cong. 2d Sess. 9, 12-15, 21 (1934); Remarks of Congressman Lea, 78 Cong. Rec. 7861-62 (1934); S. Rep. No. 1455, 73d Cong. 2d Sess. (1934); H.R. Rep. No. 1383, 73d Cong. 2d Sess. (1934); Hearings on Stock Exchange Regulation Before the House Committee on Interstate and Foreign Commerce, 73d Cong. 2d Sess. 132-35 (1934). *See also,* Manne, *Insider Trading and the Administrative Process,* 35 Geo. Wash. L. Rev. 473, 491-92 (1967); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?,* 57 Nw. U.L. Rev. 627, 652-54 (1962).

artificially affect market prices and not reflect true market conditions. *See* H. G. Manne, Insider Trading in the Stock Market (1966).

3. *Administrative History and Interpretation of the Rule*

In contrast to the legislative history of Section 10(b) which does not specifically address the issue of trading without disclosure of material, nonpublic information, the administrative history and interpretation of Rule 10b-5 is enlightening. The Rule was adopted by the SEC in 1942 to close ". . . a loophole in the protections against fraud administered by the [SEC] by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Release No. 3220 (May 21, 1942).[6] No definition of "fraud" was supplied by the SEC at the time of the Rule's adoption. The burden of later SEC interpretations of its Rule makes clear that a failure to disclose material, nonpublic information in connection with a stock transaction amounts to "fraud" within the scope of Rule 10b-5 only where the failure to disclose is in breach of an affirmative duty to disclose. *In the Matter of Cady, Roberts & Co.,* 40 S.E.C. 907 (1961); *but*

6. The Rule appears to have been adopted over the course of one or two days when the SEC realized that the antifraud provisions of the 1933 Securities Act (15 U.S.C. §77q[a]) applied only to the "offer or sale" of securities and not their purchase. The Rule was adopted in particular response to a Regional Administrator's report regarding a corporate president who, while misrepresenting to other shareholders that the corporation was doing very badly, was buying up their shares and failing to disclose that the corporate earnings were going to quadruple. When the text of Rule 10b-5 drafted in response to the report was presented to the commissioners, all approved it and the only comment made was "Well . . . we are against fraud, aren't we?" *See* Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 922 (1967) (remarks of Milton Freedman, one of the Rule's co-drafters).

compare, e.g., SEC v. *Sorg Printing Co., Inc.*, CCH Fed. Sec. L. Rep. ¶95,034 (S.D.N.Y. 1975).

Cady, Roberts & Co., supra, is the seminal SEC interpretation applying Rule 10b-5 to the nondisclosure of material, nonpublic information in connection with securities trading. The SEC ruled that Section 10(b) and Rule 10b-5 had been violated by Cady, Roberts & Co., a stock brokerage partnership and one of its partners who sold stock of Curtiss-Wright Corp., on the basis and without disclosure of highly unfavorable and unpublished dividend information obtained from a Curtiss-Wright director who was also a registered representative employed by Cady, Roberts.[7] Because the case was "of first impression and one of signal importance in [the SEC's] administration of the Federal securities acts" (*Cady, Roberts, supra,* at 907), Chairman William L. Cary painstakingly spelled out the legal principles underlying the SEC's application of Rule 10b-5 (*id.* at 911-12):

> ". . . Rule 10b-5 appl[ies] to securities transactions by 'any person.' Misrepresentations will lie within [its] ambit, no matter who the speaker may be. *An affirmative duty to disclose material information has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders. We and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the antifraud provisions.*

7. The SEC proceedings in *Cady, Roberts & Co.* were resolved by Cady, Roberts & Co.'s offer of settlement permitting a maximum sanction of a 20-day suspension of the trading partner from membership on the New York Stock Exchange. Apparently there was no referral of the matter by the SEC to the Justice Department's Criminal Division.

> * * *
>
> "Thus our task here is to identify *those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading its securities.* Intimacy demands restraint lest the uninformed be exploited." (Emphasis supplied.)

The SEC thus made it plain nearly twenty years after Rule 10b-5 was promulgated that, unlike a misrepresentation in connection with a securities transaction which is a fraud under Rule 10b-5 "no matter who the speaker may be," total nondisclosure amounts to a Rule 10b-5 fraud only when the silence is in breach of "an affirmative duty to disclose" such as the duty of one who "[is] in a special relationship with a company, . . . privy to its internal affairs . . . and trad[es] its securities."[8] This well-rea-

8. The SEC's citation in *Cady, Roberts* to *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808, 828-29 (D.Del. 1951) and *Kardon* v. *National Gypsum Co.*, 73 F. Supp. 798, 800 (E.D. Pa. 1947) as the sole judicial support for its interpretation of Rule 10b-5 makes powerfully clear that the application of Rule 10b-5 to nondisclosure in connection with a securities transaction was meant to embrace only a nondisclosure which violates an insider's duty to disclose. In *Speed* v. *Transamerica, supra,* 99 F. Supp. at 828-29, Chief Judge Leahy wrote:

> "The rule [*i.e.*, Rule 10b-5] is clear. It is unlawful for an insider, such as a majority shareholder, to purchase the stock of minority shareholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers. The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his

(footnote continued on next page)

soned interpretation of the Rule cannot be said to have been modified in any sense by the mere commencement by the SEC of injunctive actions against Chiarella and other printers, especially where none of those actions were accompanied by interpretative opinions or policy pronouncements varying from *Cady, Roberts*. *E.g., SEC* v. *Sorg Printing Co., Inc., supra*.

C. Judicial Development of Section 10(b) and Rule 10b-5

The case law regarding nondisclosure liability under Rule 10b-5 after *Cady, Roberts* and before *Chiarella* is undeviating. Liability under the section and rule for the failure to disclose material information concerning the stock of an issuer has been found *only* where the failure to disclose is in breach of an affirmative duty to disclose arising out of a fiduciary relationship the trader or the original source of the information has with the issuer or out of some other special relationship the trader has with the issuer or other investors. Absent an affirmative duty to disclose, the cases make it perfectly clear that trading on the basis of material, nonpublic information is not a violation of Section 10(b) and Rule 10b-5.

The landmark case of *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (*en banc*), *cert. denied*, 394

position to take unfair advantage of the uninformed minority stockholders."

And in *Kardon* v. *National Gypsum Co., supra*, 73 F. Supp. at 800, the court wrote:

> "Under any reasonably liberal construction, these provisions [of Rule 10b-5] apply to directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position, which would materially affect the judgment of the other party to the transaction."

U.S. 976 (1969), is illustrative. In that case the SEC sought to enjoin Texas Gulf Sulphur and several of its officers, directors and employees from violating Section 10(b) and Rule 10b-5 and to compel the rescission of securities transactions in the stock of Texas Gulf Sulphur entered into by the individual defendants on the basis and without disclosure of material, nonpublic inside information. The Second Circuit ruled that the nondisclosure violated Section 10(b) and Rule 10b-5 because the insiders had an affirmative duty to disclose inside corporate information when trading in the shares of the corporation. Relying on the SEC's decision in *Cady, Roberts, supra*, the court wrote (401 F.2d at 848):

> ". . . anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing . . . or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such information remains undisclosed."

In finding an affirmative duty to disclose in *Texas Gulf Sulphur*, the court relied on "traditional fiduciary concepts" and the "'special facts' doctrine" developed in common law tort cases involving fraud by silence (401 F.2d at 848). The essence of the common law rule is that a tort action for fraud by silence lies where one party to a business transaction fails to disclose facts material to the transaction that the other party is entitled to know because of a fiduciary or other special relation of trust and confidence between them. *See, e.g., Strong* v. *Repide*, 213 U.S. 419 (1909); *Hotchkiss* v. *Fisher*, 136 Kan. 530, 16 P.2d 531 (1932); *Oliver* v. *Oliver*, 118 Ga. 362, 45 S.E. 232 (1903); *Diamond* v. *Oreamuno*, 24 N.Y. 2d 494, 248 N.E. 2d

910 (1969); 3 L. Loss, Securities Regulation 1446-48 (2d ed. 1961); 3 Fletcher, Cyclopedia Corporations 281-92 (1975 revision); ALI Restatement of the Law 2d, Torts §551(2)(a).[9]

As Chief Judge Fuld wrote in *Diamond* v. *Oreamuno*, *supra*, 24 N.Y. 2d at 498-99, a securities fraud by silence case:

> "Just as a trustee has no right to retain for himself the profits yielded by property placed in his possession but must account to his beneficiaries, a corporate fiduciary, who is entrusted with potentially valuable information, may not appropriate that asset for his own use. . . . [T]here can be no justification for permitting officers and directors . . . to retain . . . profits which . . . they derived solely from exploiting information gained by virtue of their inside position as corporate officials."

Since *Texas Gulf Sulphur*, it has become firmly entrenched in Section 10(b) and Rule 10b-5 case law that nondisclosure amounts to a "manipulative or deceptive device or contrivance" *only* when such nondisclosure is in breach of a duty to disclose arising out of a fiduciary relationship between the trader or the original source of information and the issuer or some special trustee type of relationship between the trader and other investors.[10] *See*,

9. As the treatises point out, it was the so-called "minority rule" of the common law which imposed a fiduciary obligation to disclose upon insiders when trading the shares of their corporation. 3 Fletcher, Cyclopedia Corporations, *supra*, 288-92; 3 L. Loss, Securities Regulation, *supra*, at 1446-47.

10. In opposing certiorari, in *SEC* v. *Texas Gulf Sulphur*, *supra*, the SEC itself acknowledged that the duty to disclose arises out of the fiduciary obligation a corporate "insider" owes the corporation's shareholders. (*See* Brief for the SEC in opposition to petition for a writ of certiorari in *Coates* v. *SEC*, No. 68-897, p.17.)

e.g., *Lewelling* v. *First California Co.*, 564 F.2d 1277 (9th Cir. 1977); *Schein* v. *Chasen*, 478 F.2d 817, 823 (2d Cir. 1973), *vacated on other grounds*, 416 U.S. 386 (1974); *Radiation Dynamics, Inc.* v. *Goldmuntz*, 464 F.2d 876, 890 (2d Cir. 1972); *SEC* v. *Great American Industries, Inc.*, 407 F.2d 453, 460 (2d Cir. 1968) (*en banc*), *cert. denied*, 395 U.S. 920 (1969); *Myzel* v. *Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Kohler* v. *Kohler Co.*, 319 F.2d 634 (7th Cir. 1963). The Second Circuit wrote in 1972:

> "The essential purpose of Rule 10b-5, as we have stated time and again, is to prevent corporate insiders and their tippees from taking unfair advantage of the uninformed outsiders." *Radiation Dynamics, Inc.* v. *Goldmuntz*, *supra*, 464 F.2d at 890.

Absent such a relationship and the correlative duty to disclose, nondisclosure of material, nonpublic information is not a Rule 10b-5 violation.

> "The party charged with failing to disclose market information must be under a duty to disclose it to the plaintiffs." *Frigitemp Corp.* v. *Financial Dynamics Fund, Inc.*, 524 F.2d 275, 282 (2d Cir. 1975).

This state of the law was spelled out by the American Law Institute in its 1978 Proposed Official Draft of the Federal Securities Code.[11] In codifying the existing law regarding trading based on and without disclosure of ma-

11. The American Law Institute's Proposed Official Draft of the Federal Securities Code (1978) was the result of an intensive effort over more than eight years to codify the federal securities laws by synthesizing the myriad statutes, administrative rules and court decisions spawned since 1933.

terial, nonpublic information, the ALI made it plain that some cases of nondisclosure of material information do not involve "fraud" and hence do not come within the scope of Section 10(b). Under the proposed code such nondisclosure is "unlawful" in connection with a security transaction when an "insider" trades in the shares of his own corporation and "may be" "unlawful" when "any person" fails to disclose in breach of "a duty to act or speak." *See* ALI Proposed Official Draft of the Federal Securities Code (1978), §§1602, 1603, 262(b).[12]

Under the ALI codification or any judicial interpretation of the embrace of Section 10(b) and Rule 10b-5 prior to the Second Circuit's opinion in this case, Chiarella's nondisclosure was in breach of no duty to disclose. He was clearly not an "insider" or a "tippee" of an "insider" of the target corporations whose shares he purchased.

12. In relevant part, the ALI proposed code provides as follows:

"Sec. 1603. (a) It is unlawful for an insider to sell or buy a security of the issuer, if he knows a fact of special significance with respect to the issuer or the security that is not generally available. . . . (b) 'Insider' means (1) the issuer, (2) a director or officer of, or a person controlling, controlled by, or under common control with, the issuer, (3) a person whose relationship or former relationship to the issuer gives or gave him access to a fact of special significance about the issuer or the security that is not generally available, or (4) a person who learns such a fact from a person specified in Section 1603(b) . . . with knowledge that the person from whom he learns the fact is such a person. . . ."

"Sec. 1602. (a) It is unlawful for any person to engage in a fraudulent act . . . in connection with (1) a sale or purchase of a security . . . ."

"Sec. 262. (b) Inaction or silence when there is a duty to act or speak may be a fraudulent act."

Chiarella had no relationship whatever with those corporations. Chiarella acquired information about the "target" corporations, *i.e.*, that they were about to become the subject of tender offers, from the offerors who were themselves "outsiders," and, as we demonstrate below, free to use the information to purchase the stock about to become targeted without fear of 10b-5 liability.

The precise same analysis has been used by several courts which have squarely held that conduct identical to Chiarella's—an outsider's open market purchase of an issuer's stock based on and without disclosure of information regarding an impending tender offer for the issuer's stock where the information was not derived through any relationship with the issuer—does not amount to a Rule 10b-5 violation.

In *General Time Corp.* v. *Talley Industries, Inc.*, 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969), Talley Industries acquired shares of General Time Corp. on the open market without disclosing its plan for a merger "whose terms might be more favorable than the price paid for the stock being acquired" (*id.* at 164). The Second Circuit, two months after its decision in *Texas Gulf Sulphur*, held that there was no violation of Rule 10b-5 because in purchasing the General Time shares Talley was not utilizing information of and had no fiduciary relation with General Time. Judge Friendly wrote as follows (*id.*):

> "We know of no rule of law, applicable at the time, that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller,

had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale . . . ."[13]

Similarly, in *Mills* v. *Sarjem Corp.*, 133 F. Supp. 753 (D.N.J. 1955), the court found no Rule 10b-5 violation in the conduct of an outside syndicate which purchased all the stock of a bridge company for the purpose of reselling the gathered stock at a profit without divulging in a solicitation letter sent to stockholders its plans to resell. The court wrote (*id.* at 764-65):

"The cases imposing a duty on the part of a purchaser of shares to disclose his knowledge of future prospects and plans all involve situations where the purchaser

13. Judge Friendly's allusion to a change in the applicable law refers to enactment of the Williams Act. The purpose of that legislation was to remedy a gap in the securities laws by subjecting tender offerors and, in certain circumstances, prospective tender offerors, to disclosure requirements. Under 15 U.S.C. §78m(d)(1) takeover bidders must file with the SEC a statement disclosing, *inter alia*, the "background and identity" of the offeror, the source and amount of funds to be used in the purchase, the extent of the offeror's holdings in the target corporations, and the offeror's plans regarding the target. Additionally, the Williams Act provides protection for shareholders who elect to tender their stock (15 U.S.C. §78n[d][5], [6]), and prohibits fraud in connection with any tender offer (15 U.S.C. §78n[e]).

It is only after 5% of the target company's stock is acquired by the offeror, however, that plans regarding the target need be disclosed (15 U.S.C. §78m[d][1]). The changes in law made by the Williams Act did not otherwise affect the legality of a prospective offeror purchasing shares of a target on the open market without disclosing the impending offer. *See Gulf & Western Industries, Inc.* v. *Great Atlantic & Pacific Tea Co.*, 356 F. Supp. 1066 (S.D.N.Y.), *aff'd on other grounds*, 476 F.2d 687 (2d Cir. 1973); *Copperweld Corp.* v. *Imetal*, 403 F. Supp. 579 (W.D. Pa. 1975). Whatever policy considerations congress reflected in permitting prospective offerors to trade target stock until it acquires 5% of the target stock and thereby becomes an "insider" of the target applies with equal force to Chiarella. None of his purchases came anywhere near the 5% limit, and thus he was not and could not have been charged with a violation of the Williams Act.

holds a fiduciary position and where the knowledge has been obtained by virtue of an 'insider' position."

And *see, Pacific Insurance Co. of New York* v. *Blot*,[14] 267 F. Supp. 956, 957 n.2 (S.D.N.Y. 1967) ("The Court entertains grave doubt whether the alleged failure by the defendant, an 'outsider,' to disclose to selling shareholders the impending tender offer . . . constitutes a violation of Rule 10b-5."); *Mutual Shares Corp.* v. *Genesco, Inc.*, 384 F.2d 540, 545 (2d Cir. 1967); *Jacobsen Manufacturing Co.* v. *Sterling Precision Corp.*, 282 F. Supp. 598, 603 (E.D. Wis. 1968).

The scholars, too, teach that Rule 10b-5 is not violated by the common practice of a prospective offeror making open market purchases of shares of the target without dis-

14. In *Blot* the SEC filed an *amicus* brief setting forth its view that the purchase of an issuer's stock based on and without disclosure of nonpublic information regarding an upcoming tender offer for the stock did not violate Section 10(b) and Rule 10b-5. The SEC wrote:

". . . we . . . believe that defendant had no affirmative duty to come forward and disclose that forthcoming tender offer when purchasing shares . . . . .

". . . in order to create an affirmative duty to disclose material facts before purchasing securities . . . there must . . . be some relationship giving rise to a duty to disclose. . . .

"We believe that there is no duty to make public . . . the fact that an individual is purchasing or seeking to purchase a corporation's stock. The mere fact that such information might be of interest to prospective investors, stockholders and the corporation is insufficient to place a duty on a purchaser, and does not approach a violation of Rule 10b-5.

". . . We are inclined to believe that . . . defendant's failure to disclose his contemplated tender offer at a higher price . . . [did not] constitute a violation."

(Memorandum of the SEC submitted *amicus curiae* in *Pacific Ins. Co.* v. *Blot*, 67 Civ. 1386 [S.D.N.Y.], pp. 5-7).

closing an impending tender offer. Professor Bromberg states:

> "The prospective offeror often buys some of the target company's securities in the open market . . . before the offer is announced. *The antifraud rules are apparently not violated. . . . Although the offeror is using material nonpublic information, it is information created by itself rather than emanating from the target company. Thus it is probably not inside information about the latter company's securities. . . . In any event, if it is not obtained by 'access' to the target company, the possessor is not . . . an insider subject to trading prohibitions.*" (A. Bromberg, Securities Law: Fraud §6.3 [1969]) (Emphasis supplied.)

And in a recent treatise on tender offers, the authors wrote:

> "When a prospective tender offeror engages in market purchases of the target company's stock, presumably it is not acting upon information acquired as an insider of the target . . . . *Therefore, information concerning the planned tender offer need not be disclosed by the offeror before it makes market purchases of the target's securities.*" E. R. Aranow, H. A. Einhorn, and G. Berlstein, Developments in Tender Offers for Corporate Control, 20 (1977). (Emphasis supplied.)

See also Fleischer and Mundheim, *Corporate Acquisition by Tender Offer*, 115 Penn. L. Rev. 317, 338 (1967).

There is no meaningful distinction between Chiarella's conduct and a prospective tender offeror's open market purchase of an issuer's stock without disclosure of its own planned tender offer; analytically the conduct is the same. In each case target shares are sold by a shareholder who is

unaware that the shares are about to become the object of a takeover bid. That in one case the nondisclosing purchaser is the prospective tender offeror and in the other it is Chiarella—a "tippee" of the prospective offeror—is surely of no consequence to the selling shareholder. Since neither the prospective offeror nor Chiarella, its tippee, has any fiduciary or other relationship with the issuer or its shareholders giving rise to an affirmative duty to disclose information, neither has an "obligation to reveal circumstances that might raise a seller's demands and thus abort the sale." *General Time Corp.* v. *Talley Industries, Inc.*, *supra*, 403 F.2d at 164.

In affirming Chiarella's conviction, the Second Circuit panel majority avoided the impact of the *General Time* line of authority by reasoning that ". . . the offerors and Chiarella occupy entirely different positions with respect to trading on news of an impending tender offer" (588 F.2d at 1366). To the panel majority the difference between a prospective tender offeror's proper conduct under Rule 10b-5 and Chiarella's Rule 10b-5 felonies is that purchases of target shares by the offeror is accompanied by "substantial economic risk" whereas Chiarella has "no economic risk whatsoever" (588 F.2d at 1366-67). There is simply no authority in the language, history or judicial interpretations of Section 10(b) and Rule 10b-5 for the proposition that the degree of risk assumed by a trader is at all relevant to distinguish between legitimate and felonious conduct under the Statute and Rule.

The Second Circuit panel majority also sought to distinguish the *General Time* line of authority by the fact that Chiarella's use of the information violated a fiduciary duty he owed his employer and its customers—the offerors,

whereas when the offerors purchase target shares they merely use information they themselves create (588 F.2d at 1367-68). This distinction too is legally impotent. This Court has very specifically held that Rule 10b-5 violations are not made out by "all breaches of fiduciary duty in connection with a securities transaction." *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 472 (1977).[15] Moreover, Chiarella was not charged with having breached any fiduciary duty he may have owed his employer or its customers.

The Second Circuit's tortured distinctions amply demonstrate that there is simply no way to read Section 10(b) and the judicial development of it to glean that Chiarella's trading is prohibited, but not that of the prospective tender offeror. The distinction fashioned and relied upon by the Second Circuit to affirm—that Chiarella is a "market insider" who has "regular access to market information"—is a classic bootstrap analysis. The "test" of "regular access to market information," found nowhere in prior law, could not have been known by Chiarella or anyone else until it was read in the Second Circuit opinion.

15. In denying Chiarella's motion to dismiss the indictment for failure to state an offense, the district court distinguished the *General Time* line of authority from Chiarella's conduct by reasoning that " . . . corporate purchases [by prospective offerors of target shares] have a presumptively legitimate business purpose to promote economic growth and are appropriately made without disclosure" whereas Chiarella's use of the same information obtained from the offerors "was solely for personal profit . . ." (450 F. Supp. 95, 97). The Second Circuit specifically disavowed "relying on any concept of 'business purpose' in distinguishing Chiarella from [the offerors]" and, citing *Santa Fe Industries, Inc.* v. *Green, supra*, agreed with Chiarella that " 'business purpose' cannot be dispositive of liability under Rule 10b-5" (588 F.2d at 1368 n.15).

Of course any distinction between criminal and non-criminal conduct based on the status of a defendant defies the most rudimentary concepts embodied in due process and equal protection law.

The judicial development of the scope of Section 10(b) and Rule 10b-5 leaves no question that Chiarella's conduct is outside their scope. As Judge Meskill said in his dissent from the Second Circuit's majority opinion affirming Chiarella's conviction (588 F.2d at 1373):

> "Today's decision expands §10(b) drastically, it does so without clear indication in prior law that this is the next step on the path of judicial development of §10(b) and, alarmingly, it does so in the context of a criminal case.
>
> * * *
>
> "That today's application of §10(b) is a departure from prior law cannot be disputed (footnote omitted)."

D. The Second Circuit's New and Expansive Interpretation of Section 10(b) and Rule 10b-5

The Second Circuit panel majority rejected the well-recognized authorities reviewed above as "irrelevant" (588 F.2d at 1364), failed to heed this Court's many recent warnings in civil cases that Section 10(b) is not to be interpreted expansively (*International Brotherhood of Teamsters* v. *Daniel*, —— U.S. ——, 99 S. Ct. 790 [1979]; *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 [1977]; *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 [1976]) and, in the context of this criminal case, created a new concept of "market insider" (588 F.2d at 1364-65) and relied on that concept to affirm Chiarella's conviction. The new rule for nondisclosure liability under Section 10(b) and Rule 10b-5 announced by Chief Judge Kaufman for the majority is as follows (588 F.2d at 1365):

> "*Anyone*—corporate insider or not—who regularly receives material nonpublic information may not use

that information to trade in securities without incurring an affirmative duty to disclose. And if he cannot disclose [footnote omitted] he must abstain from buying or selling.'"[16]

As its sole support for its novel holding of Rule 10b-5 nondisclosure liability through a "test of 'regular access' to market information" (588 F.2d at 1365-66), the Second Circuit panel majority relied on this Court's decision in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972). Reliance on that case is misplaced. In *Affiliated Ute* a bank and two of its employees acted as transfer agent for shares of the Ute Development Corporation (UDC), an entity created by the government to hold assets of a group of mixed-blood Ute Indians. There were two separate markets for the shares of UDC—a primary market consisting of Indians selling to whites (including the two bank employees) through the bank as transfer agent and a resale market consisting of whites selling to whites at substantially higher prices. The bank and its two employees became market makers who were active in encouraging a resale market for the UDC shareholders' stock. They devised a plan and induced holders of stock to dispose of their shares without disclosing the resale market of which they were aware and which, in fact, they had created. This Court ruled that the special relationship between the

16. The language parallel between the "market insider" rule announced by the Second Circuit panel majority in this case and the "corporate insider" rule in *Texas Gulf Sulphur* strikingly demonstrates the new rule's departure from settled law. As quoted above, the Second Circuit (*en banc*) in *SEC* v. *Texas Gulf Sulphur* wrote:

> ". . . anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it . . . or chooses not to do so, must abstain from trading or recommending the securities concerned." (401 F.2d at 848).

bank and its employees as transfer agent and the selling UDC shareholders imposed an affirmative duty on the employees to disclose. The nondisclosure of the conditions of the resale market was held to be in contravention of Section 10(b) and Rule 10b-5.

But the concept underpinning the Second Circuit majority opinion—regular access to market information—was flatly rejected by this Court as a basis for finding an affirmative duty to disclose and Section 10(b) and Rule 10b-5 liability. Mere access by the bank and its employees to market information regarding the resale market by virtue of their role as transfer agent was rejected outright as giving rise to a disclosure duty. Mr. Justice Blackmun wrote as follows (*id.* at 152):

> ". . . if the two men and the employer bank had functioned merely as a transfer agent, there would have been no duty of disclosure here."

Rather, the duty to disclose found in *Affiliated Ute* arose from the relationship the bank and its employees had with the selling shareholders:

> "*The . . . defendants, in a distinct sense, were market makers,* not only for their personal purchases . . . , but for the other sales their activities produced. *This being so they possessed the affirmative duty under the Rule to disclose. . . .*" (Emphasis supplied.) (*Id.* at 153.)

Thus, it was not regular access to market information but the defendants' role as market maker and agent for the selling shareholder that gave rise to a duty to disclose. Very much unlike the defendants in *Affiliated Ute* Chiarella

had no relationship at all with the selling shareholders of the target corporations—he did not undertake to act for them nor did he enter the type of special relationship with them which was determinative in *Affiliated Ute*.[17]

Moreover, the Second Circuit's replacement of the traditional "corporate insider" test with its new "market insider" test portends a licentious extension of Rule 10b-5 liability to regular and accepted trading activities by security industry employees. Thus, trading without disclosure by specialists, block positioners, floor traders, arbitrageurs and risk arbitrageurs—all of whom have "regular access to market information"—would be subject to Rule 10b-5 liability. Yet the market activities of these "market insiders" has been recognized by the SEC as "necessary" in order to "increase the depth, liquidity and orderliness of trading markets." Securities Exchange Act Release No. 9950 (Jan. 16, 1973), 38 Fed. Reg. 3902, 3918 (Feb. 8, 1973); *see also*, SEC Report of the Special Study of the Options Market, H.R. Comm. Print No. 96-IFC3, 96th Cong. 1st Sess. 1-4 (1978).

The SEC itself has taken the position that unlike use of nonpublic "inside" information, use of nonpublic "market" information should not be regulated under Rule 10b-5. Ten years after *Cady, Roberts*, in transmitting its *Institutional Investor Study Report* to Congress the SEC recommended *against* the use of Rule 10b-5 to regulate the common market practice of "warehousing"—a process by which a would-be tender offeror alerts "friendly" institutional investors of an impending tender offer in order to encourage the transfer of the target company's stock to investors who are likely to be receptive to the tender offer when announced. In its report the SEC expressly noted that "different underlying principles" from those involved in the misuse of "inside" information should govern the use of "market" information. 8 SEC Institutional Investor Study Report, H.R. Doc. No. 92-64, 92d Cong. 1st Sess. xxii, xxxii (1971). The Commission stated that the "different underlying principles" does:

> "not necessarily mean that such passing on of information concerning takeovers should be permitted, but it may well mean that if such activities are to be prohibited, this should be done by a rule specifically directed to that situation rather than by an expanded interpretation of Rule 10b-5 resting on a somewhat different theory than that underlying that rule as to the obligations and duties of those who receive material undisclosed [corporate] information." (*Id.*)

The SEC's position that the use of nonpublic "market" information should not be regulated by "an expanded interpretation of Rule 10b-5" was reiterated in 1973 (Securities Exchange Act Release No. 10316 [Aug. 1, 1973], 2 SEC Docket 229 [Aug. 14, 1973]) and again this year when the SEC proposed the adoption under Section 14(e) of the 1934 Securities Exchange Act (the Williams Act) of Rule 14e-2—a specific rule aimed at regulation of the trading activities of would-be tender offerors and their tippees once a decision to make a tender offer has been formulated.

17. Thus, Chief Judge Kaufman was in error when, relying on *Affiliated Ute*, he wrote that "a duty to disclose arising out of regular access to market information is not a stranger to the world of 10b-5" (588 F.2d at 1366). It was the duty to disclose arising out of the "special relationship" the defendants in *Affiliated Ute* had with selling shareholders which is "not a stranger" to the world of the federal securities laws. *See SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 1963); *Zweig* v. *Hearst Corp.*, —— F.2d ——, CCH Fed. Sec. L. Rep. ¶96,851 (9th Cir. 1979).

Securities Exchange Act Release No. 6022 (Feb. 5, 1979), 44 Fed. Reg. 9956 (Feb. 15, 1979). Notably *not* proposed under Section 10(b) of the 1934 Act, the new proposed rule powerfully evidences what appears to be the SEC's own view that pre-tender trading without disclosure in target stock by "outsiders" *vis-a-vis* the target is not within the scope of Rule 10b-5.[18]

Perhaps recognizing, as did the SEC, that embracing the use of nonpublic market information within Rule 10b-5 departs from all prior law, the Second Circuit majority found some justification for its new and expansive rule in the policy consideration that remedial legislation, such as the 1934 Securities Exchange Act should be broadly construed to effectuate its purpose, namely to provide to all securities traders "equal access to material information" (588 F.2d at 1365). The answer is three-pronged. First, "equal access to material information" does not mean and never has meant that there must be parity of information between traders. As Chief Judge Kaufman himself noted for the panel majority:

> "We are not to be understood as holding that no one may trade on nonpublic market information without incurring a duty to disclose." (588 F.2d at 1366).

That the "equal access" test is not a controlling principle is amply demonstrated by cases like *General Time Corp.* v. *Talley Industries Inc., supra.*

18. This view by the SEC is obviously inconsistent with positions it has taken in a few enforcement actions against printers including Chiarella. *See, e.g., SEC* v. *Sorg Printing Co., Inc.,* CCH Fed. Sec. L. Rep. ¶95,034 (S.D.N.Y. 1975); *SEC* v. *Primar Typographers, Inc.,* CCH Fed. Sec. L. Rep. ¶95,734 (S.D.N.Y. 1976); *SEC* v. *Ayoub,* CCH Fed. Sec. L. Rep. ¶95,567 (S.D.N.Y. 1976); *SEC* v. *Chiarella,* No. 77 Civ. 2534 (S.D.N.Y. 1977). Each of these actions resulted in civil consent decrees with no litigation as to the viability of the Rule 10b-5 claim.

Second, and more importantly in the context of this *criminal* case, the policy of broad construction of remedial legislation runs directly afoul of the fundamental tenet of our criminal jurisprudence that criminal statutes must be strictly construed in favor of an accused. *See United States* v. *Dunn,* —— U.S. ——, 47 U.S.L.W. 4607, 4611 (June 4, 1979) and cases cited therein. Where, as here, conduct identical to Chiarella's has specifically been held to amount not even to a civil breach of Rule 10b-5 it is *a fortiori* that such conduct cannot be subject to criminal sanction. It would be cruel and senseless to impose, on pain of felony charges, a duty of disclosure on Chiarella when, in a civil context, his "tippers"—the prospective tender offerors—have no such duty.

Third, this Court very recently rejected the concept that the remedial purpose of the 1934 Securities Exchange Act can serve to broadly construe its sections. In holding that a private right of action was not to be implied in Section 17(a) of the 1934 Act, this Court wrote:

> ". . . generalized references to the 'remedial purposes' of the 1934 Act will not justify reading a provision 'more broadly than its language and the statutory scheme reasonably permit.' " *Touche Ross & Co.* v. *Redington,* —— U.S. ——, 47 U.S.L.W. 4732, 4737 (June 18, 1979).

See also SEC v. *Sloan,* 436 U.S. 103, 116 (1978).

There being no duty of disclosure on Chiarella, his silence does not amount to a "manipulative or deceptive device or contrivance" within the meaning and intendment of Section 10(b) and Rule 10b-5.

POINT II

The Second Circuit's application of an unpredictable, novel, and expansive construction of Section 10(b) and Rule 10b-5 to affirm the conviction, violated due process.

At the time Vincent Chiarella traded in stocks on the basis and without disclosure of material nonpublic information obtained without access to the issuer, conduct such as his had never before been interpreted as within the embrace of Section 10(b) or Rule 10b-5. Identical conduct had been ruled to be without their proscription. To base its decision sustaining the conviction, the Second Circuit expansively interpreted the Rule to create a new category of "market insider": any person with "regular access to market information" (588 F.2d at 1365-66).

Had Chiarella himself or any attorney he consulted, previous to his acts, sought to determine whether they were criminally violative of the Section and Rule, he would have found that they were not. At most, conceptualizing fine spun distinctions between the status of particular categories of traders, Chiarella or his attorney might have concluded that the issue had not been resolved and that there were insufficient and conflicting criteria in existence to reasonably foresee whether the conduct was meant to be covered.

Accordingly, the application of Rule 10b-5 to Chiarella's conduct violates the fair notice requirement of due process. *Dunn* v. *United States*, —— U.S. ——, 47 U.S.L.W. 4607, 4611 (June 4, 1979); *Rewis* v. *United States*, 401 U.S. 808, 812 (1971); *Bouie* v. *City of Columbia*, 378 U.S. 347 (1964); *Lanzetta* v. *New Jersey*, 306 U.S. 451, 453 (1939).

The State of the Law at the Time of Chiarella's Acts

Chiarella's case is the first criminal prosecution for the purchase of stock on the basis of undisclosed material information. As the prosecution acknowledged, the case represents a novel application of Section 10(b). It is the first litigated case of any sort—*civil* or criminal—where a court has found liability based on the purchase of stock in a corporation about to be targeted for tender offer when the information was obtained from the offeror corporations. In sustaining the conviction, the Second Circuit deemed prior law "irrelevant" and fashioned its new "test" of liability—"regular access to market information"—suggesting that it would "provide a workable rule" as capable of "resolving close cases" in the future as was the "corporate insider" concept of *Texas Gulf Sulphur* (588 F.2d at 1365-66). That the Circuit created new law and did not merely restate or reformulate existing law is frankly conceded by Chief Judge Kaufman in his opinion when he wrote that the prosecution's theory of the Rule was based on ". . . *a view [of the law] we today hold was correct.*" 588 F.2d at 1370 n.18 (emphasis supplied).

Prior judicial treatment of the Rule demonstrates the unpredictable novelty of the Second Circuit's interpretation in the case at bar. Despite the "indefinite and uncertain disclosure obligation" (*International Brotherhood of Teamsters* v. *Daniel*, —— U.S. ——, 99 S. Ct. 790, 801 [1979]) of this rather elastic Rule it has consistently throughout its history only been applied to so-called insider cases where the material nonpublic information was derived from the issuer. The sanctions of Rule 10b-5 were never invoked without there having been access directly or indirectly to the issuer corporation and thus on the use of such informa-

tion a consequent breach of a fiduciary obligation. *See generally,* 3 L. Loss, Securities Regulation 1450-56 (2d ed. 1961); 6 L. Loss, Securities Regulation 3556-76 (2d ed. supp. 1969). From the landmark opinion in *Cady, Roberts & Co.,* 40 S.E.C. 907 (1961), where Chairman Cary defined persons covered by the broad language of the antifraud provisions as those "who are in a special relationship with a company and privy to its internal affairs . . ." (*id.* at 912) to *SEC* v. *Texas Gulf Sulphur,* 401 F.2d 833 (2d Cir. 1968), where Judge Waterman held the duty to disclose information or the duty to abstain from buying or selling securities was limited to persons (or those in privity with them) "dealing in *his* company's securities" (*id.* at 848) (emphasis supplied), access to inside information of the issuer has been the *sine qua non* for 10b-5 nondisclosure liability.

This necessity of a fiduciary nexus in situations the same as the instant one was pointedly set forth by Judge Friendly in *General Time Corp.* v. *Talley Industries,* 403 F.2d 159, 164 (2d Cir. 1969):

> "We know of no rule of law . . . that a purchaser of stock, who was not an 'insider' and 'had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale. . . ."

And *see Radiation Dynamics, Inc.* v. *Goldmuntz, supra,* 464 F.2d 876, 890 (2d Cir. 1972) (". . . purpose of Rule . . . as we have stated time and time again, is to prevent corporate insiders and their tippees from taking unfair advantage . . .").

Commentators, too, have stated that the practice of a prospective offeror making open market purchases of shares

of a target without disclosing an impending tender offer is not violative of the Rule. *See, e.g.,* A. Bromberg, Securities Law: Fraud §6.3 (1969).

It was a fair and rational extension of the concept of non-liability of prospective offerors for Chiarella or any attorney he might have consulted to conclude that tippees of the offerors similarly were not liable. Indeed, Chiarella testified he believed that since an offeror corporation was not guilty of wrongdoing by open market purchases previous to a tender offer, a common practice of which he was aware, he was also acting in a lawful manner because he derived his information from that source (R.492). The same determination logically flows from the Williams Act (15 U.S.C. §78m [d][1]) which excuses disclosure of intention by the prospective offeror until it has accumulated a sufficient block of stock in the target to constitute it a major shareholder, and thus, a fiduciary.

In assessing the state of the law and Chiarella's actual or potential notice of it at the time of his conduct, it would be remiss to overlook Judge Meskill's vigorous dissent from the majority decision which in his view, "expands Section 10(b) drastically" and is indisputably "a departure from prior law" (588 F.2d at 1373).

Chiarella's acts at the time committed could hardly have been said to "plainly and unmistakably" fall within Section 10(b) and Rule 10b-5 where such disparate opinions even now address the issue.

Nor were the omens and portents of the policy underlying the securities laws so apparent that Chiarella might

be charged with having gleaned from them a clear and definite understanding that his future acts would be deemed criminal in nature. Aside from the wide divergence in theory as evidenced by the majority and dissenting opinions, the majority explicitly rejected the trial court's policy justification for distinguishing Chiarella from the prospective offerors (*i.e.*, the Pandick Press clients from whom he obtained his information). Thus, the trial court explained away the anomalous situation where at the same time Chiarella was liable his "tipper" was not by reference to a "presumptively legitimate business purpose" of the offeror which the trial court perceived as absent in Chiarella (450 F.Supp. at 97). The Appeals Court specifically disavowed the policy justification of the trial court and agreed with Chiarella that ". . . 'business purpose' cannot be dispositive of liability under Rule 10b-5" (588 F.2d at 1368 n.15) and justified its decision on other policy grounds.

Almost two years after Chiarella's acts upon which the indictment is predicated, the American Law Institute, in a thorough study of federal securities law, concluded that there was no "justification" in the present law "for imposing a fiduciary's duty of affirmative disclosure on an outsider who is not a tippee" such as Chiarella. American Law Institute, Proposed Official Draft of the Federal Securities Code, 538-39 (March 15, 1978). As the council and staff wrote in its submission to the Institute's members (*id.*):

> ". . . [I]t is hard to find justification today for imposing a fiduciary's duty of affirmative disclosure on an outsider who is not a 'tippee.' It would be convenient to have a new category of 'quasi-insider' that would cover people like judges' clerks who trade on information in unpublished opinions, Federal Reserve Bank employees who trade with knowledge of an imminent change in the margin rate [citations omitted], and perhaps persons who are about to give profitable supply contracts to corporations with which they are not otherwise connected, while excluding persons who have merely decided to go into the market in a big way. But all this does not lend itself to definition. It is difficult in the abstract to opine even on illustrative cases. Where, for example, would one place the outsider who is about to make a tender offer—or his depository bank?"[19]

The question of liability under Rule 10b-5 for the tippee of an "outsider" tender offeror is specifically noted by the ALI as a "question . . . left to further judicial development . . . as not ripe for codification." American Law Institute, Proposed Official Draft of the Federal Securities Code, §1603, comment 3(d), at 539 (March 15, 1978).

Criminally Prosecuting Chiarella's Conduct Violated the Fair Notice Requirement of Due Process.

Recognizing the necessary elastic quality of the Rule and its occasional rightful application to original sets of facts, still it is bluntly a violation of due process to apply it to conduct which could not have been discerned to be within the Rule. This constitutional infirmity in Chiarella's conviction is made manifest when considered in light

19. Doubtlessly, Federal Reserve employees and judges' clerks who trade on information received in the course of their employment would run afoul of Chief Judge Kaufman's formulation of the rule which would impose liability on "*Anyone*—corporate insider or not —who regularly receives material nonpublic information . . ." 588 F.2d at 1365.

of the policies underlying the Rule, its history, judicial interpretation which previously adjudicated identical conduct legal, and scholarly comment with respect to it. All these authorities support the conclusion that the Rule did not cover Chiarella's conduct. Neither may Chief Judge Kaufman's *ex post facto* interpretation add the requisite definiteness to cure the constitutional insufficiency.

A fundamental precept of our system of justice is the constitutional requirement of definiteness, that is, a criminal statute must "give a person of ordinary intelligence fair notice that his contemplated conduct is forbidden. . . ." *United States* v. *Harriss,* 347 U.S. 612, 617 (1954). And *see, Dunn* v. *United States,* —— U.S. ——, 47 U.S.L.W. 4607, 4611 (June 4, 1979); *Rewis* v. *United States,* 401 U.S. 808, 812 (1971); *Bouie* v. *City of Columbia,* 378 U.S. 347 (1964); *Lanzetta* v. *New Jersey,* 306 U.S. 451, 453 (1939); *compare United States* v. *Naftalin,* —— U.S. ——, 47 U.S.L.W. 4574, 4577 (May 21, 1979).[20]

Bouie v. *City of Columbia, supra,* is apposite. In that case defendants were convicted under a South Carolina statute prohibiting trespass—the entry on the premises

20. In *United States* v. *Naftalin, supra,* Naftalin conceded that his conduct amounted to a "scheme to defraud" within the meaning of Section 17(a)(1) of the 1933 Securities Act and quarreled only with whether his victims—stockbrokers—were within the protected class. Since the language of the statute plainly makes fraud in connection with the offer or sale of securities unlawful without requiring that the victim be a member of any particular class, there was no genuine notice problem. In the case at bar, where the whole question is whether Chiarella's conduct amounts to fraud within the statute or rule, unlike *Naftalin,* "the words of the statute" do not "plainly impose" liability nor has "congress . . . conveyed its purpose clearly" so that real "ambiguity . . . exists" (*id.* at 4577).

of another after receiving notice not to enter. The South Carolina Supreme Court affirmed the convictions by interpreting the trespass statute to cover the act of remaining on the premises of another after receiving notice to leave. This Court reversed the convictions and held that the retroactive application of a new and expansive judicial interpretation of a criminal statute violated due process. Mr. Justice Brennan wrote (*id.* at 352-54):

> "There can be no doubt that a deprivation of the right of fair warning can result not only from vague statutory language but also from an unforeseeable and retroactive judicial expansion of narrow and precise statutory language . . . . [A]n unforeseeable judicial enlargement of a criminal statute, applied retroactively, operates precisely like an *ex post facto* law, such as Art. I, §10, of the Constitution forbids . . . . If a state legislature is barred by the *Ex post Facto* Clause from passing such a law, it must follow that *a State Supreme Court is barred by the Due Process Clause from achieving precisely the same result by judicial construction.*" (Emphasis supplied.)

The vice in the Second Circuit's opinion is precisely that of the South Carolina Supreme Court in *Bouie,* and indeed, is an even more egregious form of it. The Circuit here retroactively expanded the coverage of Rule 10b-5 to "*Anyone*—a corporate insider or not—who regularly receives market information." Yet, to construe remaining on the premises of another after receiving notice to leave as a criminal trespass is far more predictable as a common sense protection of property rights than is importing an essentially fiduciary obligation into an area where none previously existed.

The constitutional injustice to Chiarella is powerfully evidenced by the Circuit's articulation of the "test" of "regular access to market information" and its use of that circumstance to affirm his conviction. The Second Circuit's holding that "regular access to market information" is what justifies the criminal application of Rule 10b-5 is of a piece with the government argument in *Rewis* v. *United States, supra,* 401 U.S. at 814, which this Court bluntly rejected. In *Rewis,* a Travel Act prosecution, this Court held that conducting a gambling operation frequented by out-of-state bettors was not within the Act's proscription against interstate travel with the intent to promote gambling. The government urged that the conviction should be affirmed because the Act could be construed to include the operator of a gambling operation who actively attracts business from another state. Although this Court believed that there was some support for the government's argument, it refused to uphold the conviction on the basis of the government's interpretation of the Act "because it is not the interpretation of [the Act] under which petitioners were convicted." (*Id.*)

With language of especial application to this case, this Court wrote as follows in *Rewis*:

> "The jury was not charged that it must find that petitioners actively sought interstate patronage. . . . As a result, the Government's proposed interpretation of the Travel Act cannot be employed to uphold these convictions." (*Id.*)

Similarly, the jury here was not charged that it must find that Chiarella had "regular access to market information." Simply put, the factual merits of a defense argument to the jury on that issue aside, Chiarella had an absolute right to have the jury determine "every fact necessary to constitute the crime," not an appeals court after the fact. *In re Winship,* 397 U.S. 358, 364 (1970).

Nor does the Court of Appeals' reliance on signs posted by Chiarella's employer warning against the use of confidential information and the possibility of criminal liability and several civil consent decrees settling SEC lawsuits justify its finding that petitioner "manifestly had adequate notice that his trading in target stock could subject him to criminal liability" (588 F.2d at 1369). Any notice obtained from the employer's signs or from the commencement of civil lawsuits by the SEC "manifestly" does not provide the notice and predictability due process requires.

In *Bouie, supra,* this Court rejected the contention that defendants had adequate notice of the trespass violation because a chain with a "no trespassing" sign attached had been placed on the premises by an employee of the owner (378 U.S. at 355 n.5):

> "The determination whether a criminal statute provides fair warning of its prohibitions must be made on the basis of that statute itself and the other pertinent law, rather than on the basis of an *ad hoc* appraisal of the subjective expectations of particular defendants."

That the sign and the SEC's lawsuits are not "the statute itself and the other pertinent law" sufficient to provide notice is best illustrated by the Second Circuit majority's own language (588 F.2d at 1370 n.18):

"The sign merely informed appellant of the SEC's view of the law—*a view we today hold was correct.*" (Emphasis supplied.)

And with respect to the SEC's view of the law, this Court has on a number of recent occasions rejected the SEC's interpretation of various provisions of the Securities Acts. *See, International Brotherhood of Teamsters* v. *Daniel,* —— U.S. ——, 99 S.Ct. 790, 800 n.20 (1979), and cases cited therein. Further, "less formalized custom and usage" (*Parker* v. *Levy,* 417 U.S. 733, 754 [1974]) must fairly be considered to have indicated to Chiarella the legality of his conduct. As noted above, he was keenly aware of the common and accepted practice of a prospective offeror purchasing shares of the prospective target in the open market.[21]

In sum, Section 10(b) and Rule 10b-5 as applied in this case failed to meet the constitutionally requisite standards of definiteness, whether perceived "through the eyes [of Chiarella, or] . . . his lawyer" had he consulted one. *See* Note, *Due Process Requirements of Definiteness in Statutes,* 62 Harv. L. Rev. 77, 82 (1948).

21. Chiarella's knowledge that the prospective tender offerors from whom he obtained his information were trading in the target company stocks understandably engendered his belief that what he was doing was legal. Since, as in GX31F, this conduct by the prospective offerors was disclosed in the prospectuses and thus, necessarily approved by the regulatory authorities, Chiarella was entitled to believe that it had been deemed lawful by the SEC. Such a justifiable belief on his part negates his criminal intent, and his reliance on this authoritative guidance renders his prosecution violative of due process. *Cf. United States* v. *Pennsylvania Industrial Chemical Corp.,* 411 U.S. 655 (1973); *Cox* v. *Louisiana,* 379 U.S. 559 (1965); *Raley* v. *Ohio,* 360 U.S. 423 (1959).

POINT III

The trial court failed to instruct the jury on an essential element of the crime charged, namely specific intent to defraud or deceive.

Chiarella's sole defense on the merits was that he denied having an intent to defraud. Despite consistent urgings by the defense that the jury be charged that a finding beyond a reasonable doubt of intent to defraud was a predicate to conviction and despite defense requests to charge embodying that principle,[22] the court flatly refused to charge the jury that specific intent to defraud was a requisite element of the crime.

It is fundamental that a defendant is entitled to jury instructions regarding every essential element of the crime charged. In *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976), this Court held that in a *civil* action for damages for violation of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j[b]) and Rule 10b-5 it is necessary to plead and prove "'scienter'—intent to deceive, manipulate, or defraud." *Id.* at 193. The Court concluded that by the use of the words "manipulative or deceptive device," in Section 10(b) congress intended to prohibit only "intentional or willful conduct *designed to deceive or defraud* investors." (Emphasis supplied.) *Id.* at 198-99.

In this *criminal* case, in an *a fortiori* violation of the rule announced in *Hochfelder,* the trial court never in-

22. *See* Chiarella's Requests to Charge Nos. 14, 18, 20, 21, 24-26; Supplemental Request to Charge No. 2(a).

structed that specific intent to defraud was an essential element. Rather, the state of mind the jury was instructed conviction could be premised on was "a realization on the defendant's part that he was doing a wrongful act" (R.688).

But a defendant's "realization . . . that he was doing a wrongful act" is functionally and theoretically remote from having a specific intent to defraud. The essential distinction between the two concepts is the element of purpose embraced in the specific intent concept. Thus, a person who "realiz[es]" he commits a "wrongful act" cannot necessarily be said to have acted with a specific purpose to defraud or deceive.

The difference is crucial in Chiarella's case. Because there was evidence that his employer had posted signs warning that use of "any information learned from customer's copy . . . will result in . . . being fired immediately . . . [and could result in] criminal penalties" (GX14A), the jury could easily have found that Chiarella "realiz[ed] . . . he was doing a wrongful act." He testified that he knew his conduct was in contravention of company policy and that he could have been fired for it (R.495). But Chiarella denied that he intended to defraud or cheat anyone (R.483-84) and the fact that his security transactions were all conducted anonymously over the open market was argued as circumstantial proof that he lacked the required specific intent to defraud the target company stockholders he never met and never dealt with (R.625-29).

Moreover, where the gravamen of Chiarella's "crime" was silence, the element of specific intent to defraud takes

on added significance. What distinguishes mere negligence based on silence or omission from the commission of a civil Rule 10b-5 violation predicated on similar conduct is the element of specific intent to defraud. *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 198-99. In a *criminal* Rule 10b-5 prosecution which obviously can never be based on negligence, it was particularly important for the jury to have been instructed to acquit unless they found that behind Chiarella's silence was a specific purpose to defraud or deceive.

The Second Circuit panel majority held that the trial court "correctly refused to charge the jury that the Government must prove specific intent to defraud" because the trial court charged the jury not to convict unless it found that Chiarella acted "knowingly" and "willfully" and defined those terms to mean "a realization on the defendant's part that he was doing a wrongful act . . ." (588 F.2d at 1370-71). Citing *United States* v. *Peltz,* 433 F.2d 48, 54-55 (2d Cir. 1970), *cert. denied,* 401 U.S. 955 (1971) and *United States* v. *Dixon,* 536 F.2d 1388, 1395-97 (2d Cir. 1976), the Court of Appeals reasoned that the language of the charge had been specifically approved for prosecutions, as was the instant one, brought under Section 32(a) of the 1934 Act (15 U.S.C. §78ff[a]).

In neither *Peltz* nor *Dixon* did the court deal at all with the intent requirement in a Rule 10b-5 case.[23] Both *Peltz* and *Dixon* (which in any event are pre-*Hochfelder*) deal

23. *Peltz* and *Dixon* simply cannot be read as having any bearing on the mental element required for there to be a Section 10(b) and Rule 10b-5 violation. Indeed, in *Peltz* the court was dealing with a Section 10(a) and Rule 10a-1(a) violation and in *Dixon* at issue were Section 14(a), Rule 10a-3 and Section 13.

exclusively with Section 32(a)—the general penalty provision of the 1934 Act which makes criminal any *willful violation* of any section of the Act or any rule or regulation thereunder "the violation of which is made unlawful."[24] Once another section of the Act or rule or regulation thereunder makes conduct "unlawful," Section 32(a) punishes such conduct as criminal where there is a "willful violation" of that other section or rule or regulation. Thus, a purely civil violation of a section, rule or regulation is transformed into a criminal one by proof beyond a reasonable doubt of all the essential elements required by the particular section, rule or regulation *including the requisite mental element, and in addition* establishing under Section 32(a) that the violation was "willful."

This Court in *Hochfelder* made clear that the requisite mental element for a Rule 10b-5 violation is the specific "intent to defraud." The trial court's error in charging the jury was that while it permitted the jury to find "willfulness" under Section 32(a) and the *Peltz* and *Dixon* formulation of "a realization of a wrongful conduct," it never charged the jury that a violation of Section 10(b) and Rule 10b-5 required proof of a specific "intent to defraud."

The trial court's *Peltz* and *Dixon* charge on willfulness did not and could not replace a *Hochfelder* charge on intent to defraud. A properly instructed jury should have been told *both* that intent to defraud was required before a

24. Thus, Section 32(a) provides:

"Any person who willfully violates any provision of this chapter . . . or any rule or regulation thereunder the violation of which is made unlawful . . . shall [be punished for a crime]."

Section 10(b) and Rule 10b-5 violation could be found and that if found, such violation was a crime if determined to be a willful violation, *i.e.*, that the defendant committed the violation with a realization that he was engaged in wrongful conduct.[25]

POINT IV

Chiarella's statement to the New York Department of Labor was inadmissible under Rule 501 of the Federal Rules of Evidence since the federal legislative, judicial and constitutional interests clearly favor and support the statutory privilege accorded the statement by the State of New York.

In an effort to alleviate pressing financial burdens, Chiarella sought unemployment compensation from the State of New York. During the course of processing his claim he was told to supply a statement setting forth the reasons he was discharged by his last employer and he complied with a complete and accurate account of how he came to lose his job:

> "I was discharged for violations of the company rules re: disclosure of client information. The allegation is true. It was a matter of printing of stock tender offers and I utilized the information for myself. This hap-

25. To be sure, "intent to defraud" may embrace "willfulness" thereby obviating the necessity of charging the latter separately. But the converse is not true—willfulness does not include "intent to defraud." In any event, since intent to defraud was not charged, the issue of whether intent to defraud embraces willfulness and therefore whether both need to be charged is not before the Court. Insofar as *United States* v. *Charnay*, 537 F.2d 341 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976) can be read for the proposition that "awareness of wrongdoing" satisfies the *scienter* requirement of Section 10(b) and Rule 10b-5, the case is in direct conflict with *Hochfelder*.

> pened last year and through investigation by the SEC, the matter came to light and I was discharged" (transcript of proceedings, April 3, 1978, pp. 1-24–1-28).

This statement was, under the express terms of a state statute, privileged and inadmissible in "any" court proceeding. These unequivocal legislative assurances, however, proved impotent, for within a few months a federal prosecutor subpoenaed Chiarella's signed statement and at his ensuing federal trial, over objection, paraded it before the jury as Chiarella's guilty plea (R.275).

A statement procured in this manner has no place in a federal criminal trial and should have been excluded. While Rule 501 of the Federal Rules of Evidence vests the federal criminal courts with power to formulate their own law on privileges, it also requires the courts to exercise that power after a review of federal and state interests involved in the particular claim of privilege before it. Both federal and state interests strongly favor preserving the confidentiality of the statement made by Chiarella. The admission of that statement was therefore error and given the pervasive prejudicial effect of its admission, one of sufficient magnitude to require reversal.

The State of New York mandates, in no uncertain terms, confidentiality of information provided in connection with a claim for unemployment insurance. New York Labor Law, §537 provides, as it has for over 40 years, that "information" acquired from employers or employees pursuant to the law shall be for the "exclusive use" of the commissioner "and shall not be open to the public."[26] The legislature, reaffirming the confidential and privileged nature of these communications, specified that the information so acquired shall not "be used in any court in any action or proceeding pending therein" except those actions or proceedings in which the Commissioner of the Department of Labor was a party. The legislature's commitment to this policy is underscored by its decision to punish any unauthorized disclosure of the information as a misdemeanor. The plain and explicit wording of the statute which, despite frequent legislative attention[27] has remained intact, demonstrates New York's resolve to keep the information it acquires under the law confidential and to bar its admission into evidence.

In recognition of the purposes sought to be accomplished by this explicit legislative command, the executive and judicial branches of the state have uniformly enforced the privilege created by §537. The statute, as one court put it, provided "for a positive nondisclosure of the communication . . . in court or out of court," a provision described as embodying either a "common-law variety of absolute privilege" or "a statutory privilege" with respect to the communications covered by the statute. *Coyne* v. *O'Connor*, 204 Misc. 465, 466, 121 N.Y.S. 2d 100, 101 (Sup. Ct. Nassau Co. 1953). And the underlying objective of the privilege was ably stated by the State's Attorney General. Appear-

26. The statute at the time Chiarella made his statement is set out at p. 4, *ante*.

27. The nondisclosure and penalty provisions have remained the same since 1935 when the statute (then §524 of the N.Y. Labor Law) was originally enacted (L. 1935, chap. 468, §1). Subsequent amendments to that law did not affect this language. See L. 1936, chap. 117, §9; L. 1938, chap. 266, §9; L. 1939, chap. 662, §21. In 1944, the legislature reenacted the nondisclosure provisions as Section 537 of the Labor Law (L. 1944, chap. 705, §1) and thereafter amended that section three times, each time without any change in the confidentiality provisions. See L. 1947, chap. 115, §2; L. 1948, chap. 346, §1; L. 1978, chap. 545, §5.

ing in *Coyne* as *amicus curiae* in support of a private party's assertion of the privilege, he argued "for the need of absolute privilege to cover communications such as that of the defendant [a statement of reasons for discharging plaintiff] to expedite the work of the department and encourage full and free disclosures by employers." *Id.*[28]

Consistent with the letter and spirit of the statute, the courts have time and again sustained assertions of the privilege. Information acquired from both employer and employee has been found to be privileged. *Graham* v. *Seaway Radio, Inc.*, 28 Misc. 2d 706, 216 N.Y.S. 2d 52 (Sup. Ct. Jefferson Co. 1961); *Breuer* v. *Bo-Craft Enterprises, Inc.*, 8 Misc. 2d 736, 170 N.Y.S. 2d 631 (Sup. Ct. N.Y. Co. 1957); *Coyne* v. *O'Connor, supra; Eston* v. *Backer*, 204 Misc. 162, 119 N.Y.S. 2d 273 (Sup. Ct. Queens Co. 1953); *Andrews* v. *Cacchio*, 264 App. Div. 791, 792, 35 N.Y.S. 2d 259, 260 (2d Dept. 1942); *see Conigliaro* v. *New Hampshire Fire Insurance Co.*, 8 Misc. 2d 164, 171 N.Y.S. 2d 731 (Sup. Ct. Kings Co. 1956).

In short, the statement which Chiarella made to the state agency would not have been admissible in evidence against him in any state court action. Chiarella's response detailing the reasons for his discharge was "information acquired from an employee" by the state in an effort to

28. The New York statute created what one commentator terms an "encouragement-type" privilege,

> "designed to encourage citizens to accurately report potentially self-damaging information which they would otherwise hesitate to furnish for fear of the consequences resulting from later uses of such information. While the ultimate beneficiary of this privilege is, of course, the government (in that it receives more accurate information), the privilege is basically designed to protect the immediate interests of the reporting citizen, and thus the privilege is personal, belonging to the reporter [footnote omitted]." Note, *The Required Report Privileges*, 56 Nw. U.L. Rev. 283, 286 (1961).

determine his claim for unemployment benefits and "information" has been held to include an employee's statements made in the course of processing a claim for benefits. *Andrews* v. *Cacchio, supra.* So long as the commissioner is not a party to the action in which the information is to be introduced, that information would be privileged and, upon objection, could not be introduced against Chiarella in the state courts of New York.

The criteria for determining whether this state privilege will be honored in the federal courts are set out in the Federal Rules of Evidence. Federal courts, according to Rule 501,[29] are required to apply the state law of privilege in civil actions where "the State law supplies the rule of decision" "with respect to an element of a claim or defense." In all other actions tried in federal courts the privilege of a witness, assuming it is not one provided for by the federal Constitution, act of Congress, or this Court's rules, "shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience."[30] Simply stated, in other than civil diversity cases, the federal court is required to evolve its own body of privilege law with established federal common law as a guide.

In this case, however, the federal common law as it has developed thus far provides no dispositive answer to the issue at hand. To be sure, there are instances in which

29. The full text of Rule 501 can be found at p. 4, *ante*.

30. The House Committee Report accompanying the draft of Rule 501, eventually enacted into law, discloses that this standard for assessing privilege claims in federal question cases was derived from Rule 26 of the Federal Rules of Criminal Procedure [H.R. Rep. No. 650, 93d Cong. 1st Sess. 8 (1973)] which was itself derived from the standard first announced by this Court in *Wolfle* v. *United States*, 291 U.S. 7, 12 (1934) and *Funk* v. *United States*, 290 U.S. 371 (1933).

federal courts, in federal question cases, have respected the privileged status of information provided to state agencies under a specific state statutory assurance of nondisclosure,[31] but there are examples to the contrary.[32] In any event, these federal cases involved statutory enactments whose language and underlying purposes vary considerably; they are therefore of little assistance in assessing Chiarella's claim. Turning to those reported federal cases addressing §537, we find only two. In *Simpson* v. *Oil Transfer Corp.*, 75 F.Supp. 819 (N.D.N.Y. 1948) invocation of the privilege was sustained and in *Vazquez* v. *Bull*, 91 F.Supp. 518 (S.D.N.Y. 1950) the court, expressly approving of *Simpson*, found the information sought to be disclosed was not "acquired from an employer or employee" and therefore outside the privilege. Thus, Chiarella's claim of privilege finds support in whatever federal law does exist and while those cases may not be dispositive of the issue, the privilege cannot be described, as the Second Circuit did, as one "unknown" to the federal common law (588 F.2d at 1372). Where, as here, the case law discloses no clear-cut answer, a federal court must reexamine the specific privilege asserted with an eye towards the development of federal privilege law. *E.g., In re Grand Jury Impaneled January 21, 1975, supra; see United States* v. *Allery*, 526 F.2d 1362, 1366 (8th Cir. 1975).

31. *Herman Brothers Pet Supply, Inc.* v. *N.L.R.B.*, 360 F.2d 176 (6th Cir. 1966); *In re Valecia Condensed Milk Co.*, 240 F. 310 (7th Cir. 1917); *Bearce* v. *United States*, 433 F.Supp. 549 (N.D. Ill. 1977); *Tollefsen* v. *Phillips*, 16 F.R.D. 348 (D. Mass. 1954); *In re Reid*, 155 F. 933 (E.D. Mich. 1906).

32. *In re Grand Jury Impaneled January 21, 1975*, 541 F.2d 373 (3d Cir. 1976); *United States* v. *Thorne*, 467 F.Supp. 938 (D. Conn. 1979); *United States* v. *Blasi*, 462 F.Supp. 373 (M.D. Ala. 1979); *United States* v. *King*, 73 F.R.D. 103 (E.D.N.Y. 1976).

The federal court's obligations in this regard can be understood only in light of the stormy history of Rule 501. Unlike most of the other federal rules of evidence, Rule 501 was the creation as well as the enactment of congress. The vast majority of the rules proposed by the Advisory Committee eventually made their way into the present Rules of Evidence. One noticeable exception was Article V, which, as drafted by the Committee, contained thirteen specific privilege rules intended to apply uniformly in all federal actions, civil and criminal, diversity and federal question. Rules of Evidence for the United States Courts and Magistrates, 56 F.R.D. 183 (1972) [hereinafter cited as "Proposed Rules"]. When presented for congressional approval, controversy regarding Article V prompted a legislative redrafting of the federal rules on privileges which resulted in the present form of Rule 501.

There were two basic points over which congress and the Advisory Committee disagreed. The Advisory Committee, convinced that privileges, like the other rules of evidence, were purely procedural, was desirous of establishing a uniform rule of privilege for all federal courts. It promulgated federal rules of evidence which, with two exceptions,[33] paid no heed to state-created privileges. Congress unequivocally rejected this premise. Concerned that rules of privilege involved important policy considerations, congress required the federal courts to respect state-created privileges and the policy determination underlying them in all cases where state law provided the rule of decision.

33. The first, proposed Rule 502, is of particular significance since it directed federal courts to honor state "required-reports" privileges. The second, set out in proposed Rule 510, recognized a state's assertion of the informer privilege. Proposed Rules, *supra*, 56 F.R.D. at 203-4, 255-56.

H.R. Rep. No. 650, 93d Cong. 1st Sess. 8 (1973). Although still free to adopt the Advisory Committee's specific rules of privileges for use in all federal question cases, congress did not. Faced with criticism of the Committee's codification due to its failure to incorporate several of the well-known privileges and its narrow interpretations of others, congress directed the district courts to develop privilege law under a uniform "standard" applicable both to civil and criminal cases. A flexible approach to the federal law of privilege replaced the proposed codification. The federal courts, when not directed to follow the law of the state, were given the responsibility to evolve a federal law of privilege on a case-by-case basis rather than required to interpret the specific rules proposed by the Committee.[34]

The legislative history of Rule 501 would not be complete without noting that congress took pains to point out that it did *not* reject the specific privileges promulgated by the Committee. The Report of the Senate Committee on the Judiciary explicitly stated:

> "It should be clearly understood that, in approving this general rule as to privileges, the action of Congress should not be understood as disapproving any recognition of a psychiatrist-patient, or husband-wife, or any other of the enumerated privileges contained in the Supreme Court rules. Rather, our action should

34. Detailed discussions of the legislative turmoil concerning Article V of the Rules of Evidence can be found in several commentaries. 2 J. Weinstein & M. Berger, Weinstein's Evidence §501 [01]-501[05], 501-12-501-49 (3d ed. 1977) [hereinafter cited as "Weinstein's Evidence"]; 2 D. Louisell & C. Mueller, Federal Evidence §§200-201, 389-429 (1979) [hereinafter cited as "Federal Evidence"]; Schwartz, *Privileges Under the Federal Rules of Evidence—A Step Forward?* 38 U. Pitt. L. Rev. 79 (1976); Note, *The Proposed Federal Rules of Evidence: Of Privileges and the Division of Rule Making Power*, 76 Mich. L. Rev. 1177 (1978).

> be understood as reflecting the view that the recognition of a privilege found on a confidential relationship and other privileges should be determined on a case-by-case basis." S. Rep. No. 1277, 93d Cong. 2d Sess. 6, 13 (1974).

Nor is this a surprising statement since the federal rules of evidence were the product of years of work by respected practitioners, jurists, and legal scholars. The rules went through several drafts, with the Committee consulting a broad spectrum of legal opinion. Accordingly, the rules promulgated by the Commitee and approved by the Court provide guidance to courts in the development of federal privilege law.[35]

Seen in this light, the test set out in Rule 501 can be succinctly stated. Whether a federal court should grant or withhold an evidentiary privilege requires it to balance competing policies. *United States* v. *Nixon*, 418 U.S. 683, 705 (1974). Consistent with congress' explicit concern for the social objectives sought to be achieved by the creation of privileges, courts must identify the nature and importance of those objectives. Where there is an assertion of a state-created privilege, the identification of those societal goals is facilitated by resort to state law. The court must also assess the federal interests for and against recognition of the privilege since recognition of the asserted privilege under Rule 501 is ultimately a question of federal law. The decision to honor a claim of state

35. While the vast majority of cases and comments share this view, the present significance of the proposed rules is still being debated. *Compare e.g., United States* v. *Mackey*, 405 F. Supp. 854, 857-58 (E.D.N.Y. 1975) *with SCM Corp.* v. *Xerox Corp.*, 70 F.R.D. 508, 522 (D. Conn. 1976). And *compare* Note, *The Proposed Federal Rules of Evidence: Of Privileges and the Division of Rule Making Power*, 76 Mich. L. Rev. 1177, 1179 (1978) *with* 2 Federal Evidence, *supra* at §202, 428-29.

privilege in a federal court will eventually depend upon a careful balancing of these various interests.

The cases which have sought to apply Rule 501 to a claim of state privilege have made their determinations in accord with this analysis. *E.g., United States* v. *Gillock,* 587 F.2d 284 (6th Cir. 1978), *cert. granted,* 47 U.S.L.W. 3740 (May 14, 1979); *In re Special April 1977 Grand Jury,* 581 F.2d 589, 592-93 (7th Cir.), *cert. denied,* 99 S.Ct. 721 (1978); *In re Grand Jury Proceedings,* 563 F.2d 577, 582-85 (3d Cir. 1977); *In re Grand Jury Impaneled January 21, 1975,* 541 F.2d 373 (3d Cir. 1976); *United States* v. *Allery,* 526 F.2d 1362 (8th Cir. 1975); *Gulliver's Periodicals, Ltd.* v. *Chas. Levy Circulating, Inc.,* 455 F.Supp. 1197 (N.D. Ill. 1978); *United States* v. *King,* 73 F.R.D. 103 (E.D.N.Y. 1976). And the texts dealing with the new federal evidence rules have uniformly urged the courts to apply a similar analysis. 2 Federal Evidence, *supra* at §201, 411-429; 2 Weinstein's Evidence, *supra* at §501[02], 501-17-501-20.5.

Application of these principles to the instant case strongly supports Chiarella's claim of privilege. We have already discussed the unambiguous language of New York's Labor Law, the underlying advantages to both the individual and the state by granting this privilege, and the rigorous enforcement of the privilege in the state courts. Chiarella's case provides a perfect illustration of how that very policy was effectuated. When directed to explain why he had been fired, his answer was anything but evasive. The state had the accurate information it desired without the necessity of applying its scarce resources for an investigation of the applicant. Suffice it to say, the State of New York has decided that the public

benefit derived from acquiring complete and accurate information needed for the effective administration of its unemployment insurance program outweighs the loss of such reported information in its courts. This legislative judgment should, absent a compelling federal interest, be honored by the federal courts. *See* Krattenmaker, *Testimonial Privilege in Federal Courts: An Alternative to the Proposed Federal Rules of Evidence,* 62 Geo. L.J. 61, 117 (1973).

The federal interests in preserving the confidentiality of Chiarella's statement are closely allied if not directly responsible for the privilege provided by the New York statute. The federal government, in accord with the practice of many states, has, for the same reasons as New York,[36] provided assurances of nondisclosure for those who are required to report information to various federal agencies. *E.g.,* 42 U.S.C. §1306 (Social Security returns); 42 U.S.C. §2000E-5(a) (Conciliation attempts of the Equal Employment Opportunities Commission); 38 U.S.C.A. §3301 (1972) (files and records relating to claims under the Veterans' Administration).[37] Such federally acquired information shielded by an "Act of Congress" would, of

36. This Court, in discussing one such federal regulation prohibiting the use of Internal Revenue records, identified the public policy considerations underlying it:

> "The interests of persons compelled, under the revenue law, to furnish information as to their private business affairs would often be seriously affected if the disclosures so made were not properly guarded." *Boske* v. *Comingore,* 177 U.S. 459, 469-70 (1900).

37. A list of the numerous federal statutes insuring confidentiality of the information supplied to any number of federal agencies is set forth in 2 Federal Evidence, *supra* at §202 Appendix, 445-60. A sampling of state statutes which serve similar purposes can be found in 8 J. Wigmore, Evidence §2377 (McNaughton Rev. 1961).

course, be inadmissible in a federal criminal or civil trial by the plain wording of Rule 501. *See United States* v. *Caserta,* 199 F.2d 905, 910-11 (3d Cir. 1952).

Where the federal government administers its own unemployment insurance plan (Railroad Unemployment Insurance Act, 45 U.S.C. §351 *et seq.*) it, too, grants confidentiality to the information it receives (45 U.S.C. §362[d])[38] so as to protect the privacy and identity of the reporter. But not only do the federal and New York State legislatures share the same commitment to preserving privacy in the area of unemployment insurance information, the federal government has also manifested its keen interest that all states pass similar laws. Under 26 U.S.C. §3304(a)(16) and (17), a state unemployment insurance statute, in order to meet minimum federal requirements, must provide "safeguards to insure that information [obtained by the state through administration of the state law]" is used solely for the administration of that law and that all privileges conferred by the state statute shall remain in existence.[39]

38. In words reminiscent of the New York Labor Law, 45 U.S.C. §362 provides:

> "(d) Information obtained by the Board in connection with the administration of this chapter shall not be revealed or open to inspection nor be published in any manner revealing an employee's identity: . . ."

Congress goes on to provide three limited exceptions but none of them would have authorized the Board to disclose the information it had obtained to a federal prosecutor.

39. In so doing, the federal government has demonstrated that its interests are directly served by a state statute which, by granting confidentiality, encourages accurate and complete reporting. Surely if this information promotes the efficient administration of state agencies which are required to report to their federal counterparts, the efficient administration of those federal agencies must be furthered by protecting the confidentiality and accuracy of such information.

In this manner the federal government has powerfully demonstrated the strong federal policy in favor of granting confidentiality to required reports in general and unemployment insurance information in particular. The parallel state and federal policies regarding precisely the same subject must weigh heavily against overriding the state privilege when asserted in federal court. Similar comparisons led one court to conclude that a state privilege should be recognized in a federal prosection, reasoning that "principles of federal-state comity—'a proper respect for state functions,' *Younger* v. *Harris,* 401 U.S. 37, 44 . . . (1971), reinforce this conclusion." *In re Grand Jury Proceedings, supra,* 563 F.2d at 583. For the federal government to actively encourage states to provide for confidentiality of required information and then fail to enforce those privileges when threatened in federal courts does not show "proper respect for state functions."

Moreover, there is additional strong indication from non-legislative sources of the federal commitment to respect a state "required-report" privilege in a federal case. Proposed Rule of Evidence 502 as approved by this Court would have required the district court to exclude Chiarella's statement.[40] This proposed rule and the policy behind

40. Proposed Rule 502 provided:

> "A person, corporation, association, or other organization or entity, either public or private, making a return or report required by law to be made has a privilege to refuse to disclose and to prevent any other person from disclosing the return or report, if the law requiring it to be made so provides. A public officer or agency to whom a return or report is required by law to be made has a privilege to refuse to disclose the return or report if the law requiring it to be made so provides. No privilege exists under this rule in actions involving perjury, false statements, fraud in the return or report, or other failure to comply with the law in question." 56 F.R.D. at 234-35.

it argue for sustaining the privilege in this case. One reason is that this rule was not at the heart of the controversy which surrounded the other proposed rules of privileges. It is also very significant in that it represents the one major area where the Advisory Committee, otherwise unconcerned with state law, recognized that state "required reports" statutes "embody policies of significant dimension," and specifically required a federal court to apply state law when it contained such a privilege. Proposed Rules, *supra,* 56 F.R.D. at 235.[41] The confluence of these factors justifies reliance on proposed Rule 502 as declarative of a federal policy in favor of federal recognition of the privilege guaranteed by the New York Labor Law.

The strong federal constitutional policy which underlies the Fifth Amendment's right against self-incrimination also favors recognition of Chiarella's privilege in the federal courts. Legislative enactments which require the applicant to make statements as a condition to the receipt of certain fundamental benefits, like unemployment compensation, raise the spectre of compelled self-incrimination. The Advisory Committee note accompanying its draft of proposed Rule 502 clearly recognized the constitutional

41. As one member of the Advisory Committee stated:

"By preserving state privileges for required reports, Standard 502 recognizes that the public benefit derived from acquiring fuller and more accurate information which is needed for effective governmental functioning 'outweighs the loss of the reported information to the federal court.' [Footnotes omitted.]" 2 Weinstein's Evidence, *supra* at §502[02], 502-4.

See Note, *Federal Rules of Evidence and the Law of Privileges,* 15 Wayne L. Rev. 1287, 1302-04 (1969).

considerations which necessitate the "required reports" privilege:[42]

> "A provision against disclosure may be included in a statute for a variety of reasons, the chief of which are probably assuring the validity of the statute against claims of self-incrimination, honoring the privilege against self-incrimination, and encouraging the furnishing of the required information by assuring privacy." 56 F.R.D. at 235.

In accord are four members of this Court who, dissenting from a plurality opinion, have recognized that a California statute requiring a citizen to furnish information about a traffic accident violates the Fifth Amendment's prohibition against self-incrimination. *California* v. *Byers,* 402 U.S. 424, 459-78 (1971) (Black, Douglas, Brennan, and Marshall, JJ., dissenting).

Where, as here, the state legislature has removed the danger of self-incrimination with an express proscription against the information it acquires being used in court, that use proscription should, following the dictates of the Fifth Amendment, be enforced in the federal courts. In *Murphy* v. *Waterfront,* 378 U.S. 52 (1964), this Court held that when a state grants one of its citizens "use" immunity and the citizen provides information, the grant is binding on the federal authorities and the information may not be used in any subsequent federal criminal prosecution.

This impressive array of federal interests which support recognition of the privilege in a federal tribunal

42. The Fifth Amendment implications with respect to the government's use of Chiarella's statement were raised by the defense motion for a hearing to test the voluntariness of this statement. The motion was denied without the requested hearing (R.245-48).

surely overrides any federal interest which even arguably supports a different result. There is, as the Second Circuit observed in affirming Chiarella's conviction, a "strong federal policy favoring admissibility in criminal cases" (588 F.2d at 1372), but this policy has no application to this case. The truth-determining process at Chiarella's trial would not have been perverted by the exclusion of Chiarella's privileged statement. The statement, while it had a definite and negative impact on the defense, did not significantly add to the government's evidence. The fact that Chiarella had been fired for violating his employer's policy, was amply demonstrated by other government proof. Indeed, Chiarella's statement is now considered by the government to be "cumulative" evidence of guilt which in its view "could not have affected the result" (Gov. Brief in Opposition to Petit. for Cert. at 11). In short, the federal interest in providing a fact-finder with all relevant evidence does not, in this case, offer a compelling reason to override a privilege which furthers social objectives deemed important by federal and state legislatures, not to mention the United States Constitution.

The prejudicial impact of the district court's failure to sustain the defense's repeated objections to the government's use of this evidence is readily apparent. While the government has continuously labeled any error as harmless due to the claimed cumulative nature of the proof supplied by Chiarella's statement, this argument ignores the dramatic impact of a written confession on the jury. Moreover, the prosecution made sure to highlight the prejudicial impact of this evidence. It not only introduced the confession on its direct case (GX 12; R.275-

77), but also used it to cross-examine the defendant when he testified and made substantial use of it again in summation (R.513-16, 611-14, 659-60). Equally important, however, was the statement's serious consequences on the defense. As trial counsel informed the court, "I feel constrained to advise [Chiarella] to [take the stand] in light of the fact that the statement from the State Unemployment Board was admitted into evidence" (R.334-35). In fact, this Court has itself recognized the powerful effect an improperly admitted statement may have on a defendant's decision to waive his Fifth Amendment rights and testify at trial. *Harrison* v. *United States*, 392 U.S. 219, 223-26 (1968).

Thus, on this record, the erroneous introduction of Chiarella's statement was no mere technical defect which can or should be disregarded. The error profoundly affected the defense and the jurors' deliberations as well.

Conclusion

For the above reasons, the judgment of the Court of Appeals for the Second Circuit should be reversed with instructions to dismiss the indictment.

June 28, 1979

Respectfully submitted,

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OCTOBER TERM, 1978

VINCENT F. CHIARELLA, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES

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In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-1202

VINCENT F. CHIARELLA, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A34) is reported at 588 F.2d 1358. The opinion of the district court denying petitioner's motion to dismiss the indictment (Pet. App. B1-B3) is reported at 450 F. Supp. 95.

JURISDICTION

The judgment of the court of appeals was entered on November 29, 1978. A petition for rehearing was

denied on January 4, 1979. The petition for a writ of certiorari was filed on February 2, 1979, and was granted on May 14, 1979. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether petitioner's purchase of securities based on material non-public information converted from the customers of the financial printing firm that employed him violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

2. Whether petitioner had fair notice that his conduct was prohibited by Section 10(b) and Rule 10b-5.

3. Whether the district court's instructions to the jury on mens rea were correct.

4. Whether the district court correctly received in evidence an admission by petitioner that was privileged under state, but not federal, law.

STATUTES AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 32 of the Securities Exchange Act of 1934, 15 U.S.C. 78ff, provides in pertinent part:

> (a) Any person who willfully violates any provision of this chapter, or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter * * * shall upon conviction be fined not more than $10,000, or imprisoned not more than five years, or both * * * but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud, [or]
>
> * * * * *
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT

1. Following a jury trial in the United States District Court for the Southern District of New York, petitioner was convicted on 17 counts of securities fraud, in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and SEC Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5. The district court sentenced petitioner to concurrent terms of one year's imprisonment on counts 1 through 13 of the indictment, all but one month of which was suspended. Imposition of sentence was suspended on the last four counts, and petitioner was placed on five years' probation (Pet. App. A6 n.7).[1]

The evidence showed that petitioner worked for more than 20 years at Pandick Press, a financial printing firm located in New York City, rising from the level of linotype operator and copy cutter to become a mark-up man earning over $22,000 per year (Tr. 182-186). Pandick Press provided financial printing services for investment bankers, law firms, and corporations. It frequently prepared prospectuses, registration statements, offering circulars and other documents used to disclose material facts to the investing public as required under the federal securities laws (Tr. 283). As a mark-up man, petitioner was virtually the first person in the composing room to

[1] Petitioner's actions were also the subject of a civil enforcement proceeding filed by the SEC. Petitioner consented to a final order that permanently enjoined him from future violations of Sections 10(b) and 14(e) of the Securities Exchange Act and SEC Rule 10b-5. He also agreed to disgorge the profits resulting from his illegal activities. *SEC* v. *Chiarella*, SEC Litigation Release No. 7935 (May 25, 1977).

handle the documents of Pandick's customers (Tr. 181-182).

Because of the highly confidential nature of much of Pandick's financial printing business (Tr. 284-290, 344-345), the firm had a long-standing rule forbidding employees to disclose or use for personal advantage any information contained in documents submitted by customers (Tr. 190). In the summer of 1975, following the filing of an SEC injunctive proceeding against another printing firm as a result of misuse of non-public information contained in draft tender offer prospectuses, Pandick Press formally warned its employees that misuse of information contained in customer documents was both improper and illegal (Tr. 200-212, 285-287; Gov. Ex. 54).[2] Pandick Press posted 8" by 10" notices in large, bold-face print, stating the following (Tr. 200; Gov. Ex. 14A):

> TO ALL EMPLOYEES:
>
> The information contained in all type set and printing done by Pandick Press, Inc., is the private and personal property of the customer.
>
> You are forbidden to use any information learned from customer's copy, proofs or printed jobs for your own or anyone else's benefit, friend or family or talking about it except to give or

[2] The complaint in *SEC* v. *Sorg Printing Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,767 (S.D. N.Y.), filed on August 21, 1974, charged that several employees at Sorg had violated Section 10(b) and Rule 10b-5 by using material non-public information concerning forthcoming tender offers to purchase the securities of target companies.

receive instructions. Any violation of this rule will result in your being fired immediately and without warning.

In addition, you are liable to criminal penalties of 5 years in jail and $10,000 fine for each offense.

If you see or hear anybody violating this, report it immediately to your supervisor or to Mr. Green or Mr. Fertig. Failure to report violations will result in your being fired.

These large warning notices were posted by the punch clock that petitioner used every day and in the hallway leading from the elevator to the composing room where he worked (Tr. 206-210; Gov. Ex. 13). Pandick also posted additional warning signs on its bulletin boards, distributed warnings in pay envelopes sent to all employees, and printed warnings on the back of the employees' punch cards (Gov. Exs. 15, 16, 17; Tr. 201-202). To assure further that this message was conveyed, Pandick distributed warning cards to all of its employees and requested that they sign and return them (Tr. 202, 286, 525-529; Gov. Exs. 18, 64).[3]

In addition to working at Pandick Press, petitioner was an active stock market trader (Tr. 472). He communicated with his broker between 10 and 15 times per day (Tr. 473), studied financial literature, and, when possible, watched the "ticker" at his broker's office (Tr. 474). Based on the confidential information available to him at Pandick Press, petitioner devised a scheme to improve his returns in the stock market. The scheme involved ascertaining the identities of companies subject to forthcoming tender offers or acquisitions through use of the confidential documents entrusted to him by the customers of Pandick Press. Because the customers submitted tender offer draft prospectuses with the names of the target corporations left blank or in code, petitioner went to extraordinary lengths to determine the identities of the target companies.[4] He did this by making note of facts contained in draft prospectuses, such as the market on which the stock was traded, the number of outstanding shares, the par value of the stock, and the high and low bids for the preceding year, and comparing the information with that contained in stock guide books he had obtained from his broker (Gov. Exs. 11A, 11B, 11C, 11D). Petitioner admitted to another employee at Pandick Press that he used this technique to determine the identities of target corporations and that he purchased stock on the basis of the non-public information he learned (Tr. 353-354).

Between September 1975 and November 1976, petitioner purchased the stock of five target companies whose identities he discovered by deciphering confidential material submitted by customers of Pandick

[3] The text of the warning cards appears in the Appendix, *infra*.

[4] In order to preserve strict confidentiality, the offering corporation would either use a fictitious name for itself and its target or would leave that information blank with sufficient space to permit the type to be set accurately at the last minute. See Pet. App. A3; Gov. Exs. 22-1, 23A, 28, 31, 34, 38, 60.

Press (Gov. Exs. 60, 61, 62; Tr. 394-399). Petitioner telephoned his broker and instructed him to purchase stock in each of the target companies for his margin account (Gov. Exs. 6, 7, 10, 61; Tr. 75, 117-119). As a result of those orders, petitioner received confirmations of purchase by mail.[5] Petitioner told his broker that he was buying the stocks to make a quick profit (Tr. 102). He did not disclose to his broker or any seller, however, that he had based his investment decisions on confidential information obtained covertly from customers of Pandick Press (Tr. 74, 96, 103, 114, 353-354).

Within days or hours after petitioner purchased the stock, the offering companies publicly announced their take-over plans (Gov. Exs. 50, 51, 52, 53, 44, 45, 46, 47A, 48). The price of the stock of the target companies rose sharply. Petitioner sold out immediately thereafter, realizing over $30,000 in profits (Gov. Exs. 7, 10, 61).[6]

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[5] Each count of the indictment charged that petitioner used the facilities of interstate commerce in furtherance of his scheme by causing confirmation slips to be sent through the mails by his broker. The indictment focused on petitioner's purchase of stocks issued by five different companies: Counts 1-2 (USM Corp.); Counts 3-10 (Riviana Foods, Inc.); Counts 11-12 (Foodtown Stores, Inc.); Count 13 (Booth News papers, Inc.); Counts 14-17 (Sprague Electric Co.).

[6] All of the companies whose stocks petitioner purchased were subject to tender offers, except for Riviana Foods, which was involved in a negotiated merger. Petitioner's purchases and sales involved as many as 3200 shares on one occasion, 2300 shares on another occasion, and 1100 shares on another (Pet. App. A4 n.3).

Petitioner's purchases of the target stocks represented, in some cases, a substantial portion of the total daily trading in those stocks. For example, his purchase of Riviana Foods, Inc., on February 6, 1976, amounted to approximately one-half of the total volume of the company's stock traded that day (Tr. 421). Similarly, his purchase of Foodtown Stores, Inc., on October 11, 1976, amounted to one-half of the total trading volume (*ibid.*). None of the persons who sold their stock to petitioner knew that the companies were about to become the targets of tender offers or mergers (Tr. 353). The information concerning the forthcoming acquisitions was material information that would have affected the investment decision of those sellers (*ibid.*).[7] Investors who had sold their stock to petitioner testified that they would not have done so if they had been told that the issuer companies were about to become merger partners or targets of tender offers (Tr. 360, 372, 375, 384).[8]

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[7] Petitioner stipulated as follows (Tr. 353):

> If called as witnesses to testify at trial, the sellers of the shares of common stock listed in the indictment from whom Chiarella purchased the stock and any intermediary brokers would testify that they did not know that the company's stock they were selling was about to be the subject of a tender offer or merger.

Because acquiring firms typically offer a premium to stockholders to obtain their shares, the imminence of a tender offer or merger is a material fact, as petitioner stipulated (*ibid.*):

> It is further stipulated that information concerning upcoming tender offers or mergers is material.

[8] One of the sellers, an employee of one of the target companies (Sprague Electric Co.), testified that he noticed that the price of the company's stock was rising prior to the

Petitioner was the only defense witness. He admitted that he had ascertained the names of the target companies by using the confidential documents submitted by Pandick's customers and had purchased the securities described in the indictment on that basis (Tr. 474-477).[9] Although petitioner denied that he intended to defraud anyone (Tr. 483-484) and asserted that his actions were no different from those of tender offerors who purchase limited quantities of stock on the open market without disclosure (Tr. 491-492), petitioner acknowledged that he knew that "it was wrong to use confidential information for personal gain" (Tr. 497; see also Tr. 495-496, 498, 500-502, 509, 512) and that such use could lead to discharge (Tr. 479-480, 495). When confronted on cross examination with the large warning signs at Pandick Press describing applicable criminal penalties, petitioner testified that he had never read

announcement of the tender offer and shortly after his sale. He inquired within his company about the reason for the price rise, but the vice president of the company replied that he did not know (Tr. 362-363). Another seller, who was a professional security analyst, sold shares of USM Corporation to petitioner shortly before announcement of the tender offer. He testified that, despite his professional training, he was unable to perceive that a tender offer was imminent on the basis of available public information (Tr. 369-372).

[9] Petitioner stipulated that the mails were used in conjunction with these transactions (March 1978 stipulation, ¶¶ 1, 2). He further stipulated that he "did not tell anyone or communicate any information he may have had regarding the subject of a tender offer or merger in connection with the purchases of stock listed in the indictment" (*id.* at ¶ 4(a)).

the signs even though he had passed them more than 640 times (Tr. 502-508).[10]

Petitioner testified that he realized that he had been fired by Pandick Press "because I was using insider's information" (Tr. 514).[11] When asked whether he knew that it was against the law to trade on the basis of insider information, he said, "I didn't know it was a criminal law. * * * It was a violation, as far as I knew" (Tr. 515). When pressed on that point, petitioner admitted that he realized that use of insider information "was against the SEC" (Tr. 516).[12]

2. The district court instructed the jury that before it could return a verdict of guilty it must find beyond a reasonable doubt that petitioner employed a device, scheme, or artifice to defraud, or engaged in an act, practice or course of business that operated or would operate as a fraud or a deceit, as charged in the indictment; that petitioner did so knowingly and

[10] At petitioner's sentencing hearing, the district court characterized that testimony as "perjury beyond a reasonable doubt" (Pet. App. A17 n.18).

[11] When petitioner was discharged for trading on the basis of confidential information, he did not protest but simply said: "I understand" (Tr. 234-235).

[12] Petitioner also admitted having read about insider trading cases in the newspaper (Tr. 518):

Q. You also knew that it was wrong against SEC rules to use inside information, is that right?

A. What I read in the papers, cases that I have.

Q. So the answer is yes?

A. Yes.

willfully; that the fraudulent conduct occurred in connection with a purchase or sale of securities; and that the mails were used in furtherance of the fraudulent scheme (Tr. 681-683). The court further instructed the jury that, to sustain a charge of fraudulent trading on the basis of material non-public information, the jury would have to find beyond a reasonable doubt both that the information was non-public and that it was not disclosed in connection with the stock transaction (Tr. 685-686).

The court defined "willful and knowing" conduct for the jury, stressing that such conduct is voluntary, intentional and deliberate and not a result of "innocent mistakes, negligence or inadvertence" (Tr. 688). The court added that the government must prove (*ibid.*):

> a realization on the defendant's part that he was doing a wrongful act, * * * and that the knowingly wrongful act involved a significant risk of effecting the violation that occurred.

The court also told the jury that evidence admitted during trial showing that certain tender offerors sometimes buy securities on the open market before filing disclosure statements may be considered in determining whether petitioner acted with the understanding that his conduct was wrongful (Tr. 689). It pointed out in this connection (Tr. 692):

> The central issue I suggest to you is what was Mr. Chiarella's state of mind when he was engaged in any one of them, using the clues and decoding the information, as he testified, knowing that this violated company policy? Did he have any realization that he was doing a wrongful act or did he not? Did he believe that because he had an awareness a corporation could properly purchase stock in a target company without revealing its intent to make a tender offer, that he could under the circumstances figure out the target companies' names and purchase their stock for his own personal gain without its being a wrongful act on his part?

The jury subsequently returned its verdict of guilty on all 17 counts of the indictment (Pet. App. A6).

3. The court of appeals affirmed the judgment of conviction, one judge dissenting (Pet. App. A1-A34). The court held that petitioner's secret conversion of information provided in confidence by the acquiring companies, and his use of that information to purchase securities, operated as a fraud on the acquiring companies (*id.* at A13 & n.14). The court underscored the importance to acquiring companies of preserving the secrecy of their acquisition plans and avoiding trading or leaks that could cause "an anticipatory rise in the market price of the target company's stock" (*id.* at A3, A12-A13). The court also held that petitioner's use of confidential information converted from the acquiring companies operated as a fraud on the persons who sold him securities (*id.* at A6-A9).

The court of appeals concluded that, in these circumstances, petitioner was under a duty either to abstain from trading or to await public disclosure of the information before purchasing securities from uninformed investors (Pet. App. A6-A9). While the

court did not hold "that no one may trade on non-public market information without incurring a duty to disclose" (*id.* at A10), it concluded that such a duty applied to petitioner, who had "converted to his personal use confidential information entrusted to him in the course of his employment" (*id.* at A13). The court added that "[i]t is difficult to imagine conduct less useful, or more destructive of public confidence in the integrity of our securities markets, than Chiarella's" (*id.* at A15).

The court of appeals rejected petitioner's contention that he did not receive fair notice that his conduct violated Section 10(b) and Rule 10b-5. It noted that although "the precise fact pattern at issue here" had not been addressed in prior decisions (Pet. App. A15), imposition of liability was a logical and predictable application of prior authorities, and that the SEC's earlier charges of antifraud violations by other printers engaged in identical practices provided substantial warning. The court pointed out that petitioner received additional notice of potential criminal liability by the posters that were placed throughout the premises of Pandick Press, observing that "[f]ew malefactors receive such explicit warning of the consequences of their conduct" (*id.* at A17).

The court also ruled that the charge to the jury concerning petitioner's state of mind complied with this Court's holding in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) (Pet. App. A17-A20). It observed that *Hochfelder* had established that the scienter requirement of Section 10(b) and Rule 10b-5 precluded imposition of liability in a private action for

damages on the basis of negligent misstatements or omissions. That holding, the court reasoned, does not bar a criminal conviction where the government proves a willful and knowing scheme to defraud, undertaken with the realization that the behavior in question is wrongful.

Judge Meskill dissented, concluding that application of the "disclose or abstain" doctrine to persons in petitioner's position was a departure from prior law. In his view, petitioner did not "owe[] a duty of disclosure to the sellers of target stock" (Pet. App. A29), and any breach of duty owed to the acquiring companies whose information petitioner admittedly converted constituted a mere breach of fiduciary duty, not fraud (*ibid.*). Judge Meskill concluded that a criminal prosecution in the circumstances of the present case violated principles of due process, since "fair notice" of potential liability did not emanate "from the language of the statute itself, from prior judicial interpretation, or from established custom and usage" (*id.* at A32).

SUMMARY OF ARGUMENT

I.

Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b), proscribes any deceptive device or contrivance used in connection with a Securities purchase or sale if prohibited by the rules of the Securities and Exchange Commission. SEC Rule 10b-5, 17 C.F.R. 240.10b-5, broadly prohibits the use in connection with a securities transaction of any device, scheme, or artifice to defraud, or any practice that

operates or would operate as a fraud on any person. Congress intended Section 10(b) to serve as a "catch-all." The statute reaches all new "cunning devices" used to commit fraud, especially those devices that "fulfill no useful function." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 203-206 (1976). As this Court has frequently noted, Congress enacted the anti-fraud provisions of the federal securities laws " 'to achieve a high standard of business ethics . . . *in every facet of the securities industry.*' " *United States* v. *Naftalin*, No. 78-561 (May 21, 1979), slip op. 6 (emphasis in original).

1. Petitioner violated Section 10(b) and Rule 10b-5 by converting confidential information belonging to the customers of his printing firm and using that information for personal enrichment in the stock market. His secret misappropriation operated as a fraud on the businesses that entrusted him with that information. The court of appeals properly characterized petitioner's conduct as "conversion"; in the words of the district court, it was equivalent to "embezzlement" (Pet. App. A13, B2).

Misuse of confidential information concerning impending tender offers and acquisitions can disturb market prices and prematurely reveal acquisition plans, contrary to the interests of the acquiring companies. Thus, petitioner's misappropriation placed his interests in direct conflict with those of the acquiring companies to whom he owed a duty of confidence. As their agent, petitioner had an obligation to disclose his actions. Under common law principles, failure of an agent to disclose self-dealing or conflicts of interest affecting the subject matter of the agency is a form of deceit. It also violates Section 10(b) and Rule 10b-5 where, as in this case, the agent's fraud occurs in connection with a securities purchase or sale. Here, as in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 10-13 (1971), concealed misappropriation by a fiduciary, achieved through the vehicle of a securities transaction, constitutes a violation of the statute and the rule.

2. Petitioner's use of converted information for personal financial gain also operated as a fraud on the uninformed investors who sold him securities. At common law, a purchaser was not privileged to take advantage of a seller by use of material information inaccessible to the seller if that information was obtained through unlawful methods. The rule of *caveat emptor*, which was designed to reward astuteness and penalize heedlessness, did not apply to exploitation of uninformed sellers through converted information that the seller, no matter how diligent, could not have lawfully obtained.

Moreover, under the federal securities laws the "philosophy of full disclosure" long ago superseded that of "*caveat emptor*." See *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972). Consistent with this statutory philosophy, the decisions of the lower courts have uniformly held that persons who misappropriate confidential commercial information and who use that information for personal enrichment in the stock market infringe the statute and the

rule. See, *e.g.*, *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

The fact that petitioner's fraud involved the misappropriation of important information directly related to the market price of the securities that he purchased, rather than information about the earning power of the companies that issued those securities, underscores, rather than minimizes, the illegality of his actions. Foreknowledge of an acquisition or tender offer—events entailing a sudden and substantial increase in market values—is certain knowledge that the stock of the target company is worth significantly more than its owners believe. Obtaining that information by contrivance in order to exploit uninformed investors is an act of dishonesty and deception that the securities laws properly should and do condemn.

This Court's decision in *Affiliated Ute Citizens* v. *United States*, *supra*, establishes that the failure of purchasers to disclose to sellers important facts relating to the market price of securities can violate Section 10(b) and Rule 10b-5. The defendants in *Ute* bought securities based on information concerning their market price that the defendants obtained by virtue of their privileged position in the market place. Financial printers also occupy such a privileged position. Petitioner was entrusted with highly material and confidential information that would cause substantial unfairness and unjust preferences if selectively revealed or misused. It was his job to help prepare disclosure documents for dissemination to all investors on an equal basis. He perverted that

function by using the information to enrich himself. His conduct is wholly at odds with "[t]he high standards of business morality" exacted by the federal securities laws. *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 201 (1963).

Petitioner's conduct bears no resemblance to that of tender offerors or other business firms that purchase securities (within statutory and regulatory limits) while in possession of information about market conditions generated by their own bona fide commercial activity. The securities laws have never been interpreted in such a manner as to preclude legitimate economic activity. Petitioner's conversion and misuse of material confidential information, by contrast, was harmful to the bona fide business activity of acquiring companies and to the investing public. His activities present a clear example of deceptive conduct that can "fulfill no useful function." *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 204-205, 206.

II.

Petitioner received fair notice that his conduct could result in the imposition of criminal sanctions. The literal language of Section 10(b) and Rule 10b-5 placed him on notice that all deceptive devices and contrivances practiced in connection with a securities transaction violate the law. Prior to his actions, the lower courts repeatedly had denounced insider trading (*SEC* v. *Texas Gulf Sulphur Co.*, *supra*) and this Court had held that frauds involving the misuse of

market information relating to the value of securities were forbidden (*Affiliated Ute Citizens* v. *United States*, *supra*). Lower court decisions had also established that use of information concerning impending corporate acquisitions to purchase target company stock violated the statute and the rule (*SEC* v. *Shapiro*, 494 F.2d 1301, 1303-1307 (2d Cir. 1974)). Similarly, the SEC had commenced well-publicized enforcement proceedings against printers who had misused confidential data concerning forthcoming tender offers (*SEC* v. *Sorg Printing Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,767 (S.D. N.Y. 1974)). Moreover, prior to petitioner's actions, the Department of Justice had instituted criminal prosecutions in many cases where willful violations of Section 10(b) and Rule 10b-5 were found to exist.

As the court of appeals pointed out, this case presents no abstract question concerning the sufficiency of notice provided by statute books and judicial opinions. Petitioner received explicit warning from large posters placed throughout his printing firm that use of confidential information for securities trading would subject him to fines and imprisonment. Few malefactors ever receive such specific and personal warning about the consequences of their actions.

Furthermore, the district court instructed the jury that it could not find petitioner guilty unless the government proved beyond a reasonable doubt that he acted willfully and knowingly with the understanding that his conduct was wrongful. Thus, there is no question here of convicting a defendant who believed that his actions were proper. This Court repeatedly has held that, where a defendant acts with *mens rea*, constitutional standards of fair notice are satisfied even if the prohibitory language of the statute is general or, indeed, even if the precise boundaries of the statute are subject to debate. Where a defendant consciously acts in a manner that he knows to be wrongful, and where his conduct is fairly encompassed by the literal terms of the criminal statute, the Due Process Clause does not stand in the way of his conviction. See, *e.g.*, *Nash* v. *United States*, 229 U.S. 373, 377 (1913); cf. *United States* v. *United States Gypsum Co.*, 438 U.S. 422, 438-441 (1978) (defendants may be convicted of "rule of reason" violations under the antitrust laws where *mens rea* is proven).

III.

The district court's charge to the jury emphasized that it could not find petitioner guilty unless it concluded that he acted willfully and knowingly, with consciousness that his conduct was wrongful. The court specifically instructed the jury that it could not convict petitioner if his actions were merely negligent. That instruction comports in all respects with *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976). *Hochfelder* held that Section 10(b) and Rule 10b-5 require proof of scienter as opposed to simple negligence. The scienter standard is satisfied by proof of knowing and willful misconduct. At common law, knowing and willful conduct was equivalent to scienter. The lower

courts uniformly have held that such proof satisfies the scienter standard adopted in *Hochfelder*.

The district court properly rejected petitioner's proposed instruction that the jury must find an "evil ambition to injure someone." That instruction not only misstates the law but also has no logical application in a case of this kind. Persons trading on the basis of material non-public information on impersonal securities exchanges are unaware of the identities of other traders. They rarely entertain an evil ambition to injure a victim. Their only intent is to make a profit and avoid detection. If criminal or civil sanctions are to be available in cases involving trading on material non-public information, the statute and the rule cannot be construed to require an evil ambition to injure some victim. Proof of knowing and willful misconduct, undertaken with a realization of its wrongfulness, is a sufficient showing of *mens rea* in a criminal prosecution of this kind. *United States* v. *United States Gypsum Co.*, *supra*, 438 U.S. at 443-446.

IV.

The district court's receipt of an admission made by petitioner to the New York Department of Labor did not constitute reversible error. Under New York law, the Department of Labor may disclose statements given in connection with unemployment insurance benefits in a number of different situations, and the Department discloses such statements to the FBI. Indeed, the New York Commissioner of Labor approved use of petitioner's admission in the present

prosecution. Thus, receipt of this evidence did not infringe any state policy.

The federal policy in favor of admissibility is expressed in Fed. R. Evid. 402 and 501, which authorize the receipt of all relevant evidence in criminal trials unless barred by the Constitution, a federal statute, or the federal common law. No principle of federal constitutional, statutory, or common law requires exclusion here. In the circumstances of this case the district court properly declined to erect a new federal privilege. See *United States* v. *Nixon*, 418 U.S. 683, 708-713 (1974). Moreover, receipt of petitioner's admission, even if erroneous, was clearly harmless. The government proved the substance of the admission through independent and uncontradicted evidence. Receipt of this cumulative evidence could not have affected the outcome of the trial.

ARGUMENT

I. PETITIONER'S SECRET CONVERSION OF MATERIAL CONFIDENTIAL INFORMATION FROM THE CORPORATIONS THAT RETAINED HIS PRINTING FIRM, AND HIS USE OF THAT INFORMATION TO PURCHASE SECURITIES FROM UNINFORMED INVESTORS, VIOLATED SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SEC RULE 10b-5

Petitioner admits that he converted confidential information from the corporations that entrusted his printing firm with their documents (Br. 6-7) and that he used that information to purchase stock from unsuspecting investors (*ibid.*). He has stipulated that

the information he converted was of material importance and that he made no disclosure to anyone before purchasing the securities (and then quickly reselling them at a large profit to himself) (see pages 9-10, *supra*). Petitioner contends, however, that his conduct cannot be deemed to be fraudulent under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), or Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, because he was not "an 'insider,' the 'tippee' of an 'insider', or one with a special relationship with other traders and investors" (Br. 13).

The court of appeals correctly rejected petitioner's contention, in recognition of the well established principal that Section 10(b) and Rule 10b-5 apply to "any" fraudulent scheme (*Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972)) and are not limited to frauds involving "inside" corporate information or trading between persons having an arbitrarily defined "special relationship." As this Court recently noted in *United States* v. *Naftalin*, No. 78-561 (May 21, 1979), slip op. 6, the antifraud provisions of the federal securities laws were intended "'to achieve a high standard of business ethics . . . *in every facet of the securities industry*'" (emphasis in original). As we demonstrate below, petitioner committed fraud against both the acquiring corporations whose information he converted and the investors who sold him securities in ignorance of forthcoming market events of critical importance. Since petitioner's fraud occurred "in connection with" his

purchase of securities, it constituted a violation of the statute and the rule.[13]

A. Section 10(b) And Rule 10b-5 Apply To Any Deceptive Practice Used In Connection With A Purchase Or Sale Of Securities, Not Just The Species Of Fraud Involving Insider Information Or A Special Relationship Between Buyer And Seller

In considering petitioner's assertions regarding the limited scope of Section 10(b) and Rule 10b-5, the primary guide must be the language of the statute and the rule. See *Touche Ross & Co.* v. *Redington*, No. 78-309 (June 18, 1979), slip op. 7 ("as with any case involving the interpretation of a statute, our analysis must begin with the language of the statute itself"); *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 472 (1977); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976). The literal language of the statute and its implementing rule prohibits *all* frauds, not just certain categories of fraud. Section 10(b) provides that it is unlawful for "any person," "directly or indirectly," to "use or employ, in connection with the purchase or sale of any security * * * any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of

[13] This is a criminal prosecution brought by the United States to enforce the federal securities laws. It does not present the complications often involved in private actions, including questions of standing to sue and the scope of private redress. See *United States* v. *Naftalin*, *supra*, slip op. 5 n.6.

investors." Pursuant to this broad mandate, Rule 10b-5 prohibits the use of "any device, scheme or artifice to defraud," and also forbids any person "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person" in connection with a securities purchase or sale.

The statute and rule could hardly have employed broader terms. There is no limitation on the category of persons who may violate the statute or rule. Nor is there a limitation on the category of fraud or on the identity of the victim. The antifraud provisions apply to "any person" and extend to "any" fraudulent device or contrivance, whether practiced directly or indirectly. See *Affiliated Ute Citizens* v. *United States*, *supra*, 406 U.S. at 151 (footnote omitted):

> These proscriptions, by statute and rule, are broad and, by repeated use of the word "any," are obviously meant to be inclusive. The Court has said that the 1934 Act and its companion legislative enactments embrace a "fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."

Accord, *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 9-13 & n.7 (1971) (quoting *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)); *United States* v. *Naftalin*, *supra*, slip op. 3-8. Thus, the literal text of the statute and the rule provide no support for the argument that

they should be limited to frauds practiced by "insiders" or "tippees," or to frauds involving a "special relationship" between buyer and seller.

Where a defendant's scheme to defraud involves "deception," "manipulation" or "non-disclosure," as opposed to simple breach of fiduciary duty (*Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 476 (1977)), is accompanied by "scienter" rather than negligence (*Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214 (1976)), and involves the purchase or sale of securities and the facilities of interstate commerce, the broad prohibitions of Section 10(b) and Rule 10b-5 apply at face value. As this Court emphasized in *Hochfelder*, Section 10(b) was conceived as a "catch-all" to "deal with new manipulative or cunning devices." 425 U.S. at 203. Quoting from the remarks of Thomas Corcoran, a spokesman for the drafters of the legislation, the Court concisely summarized the statute's prohibition: " 'Thou shalt not devise any other cunning devices.' " *Id.* at 202. See also S. Rep. No. 792, 73d Cong., 2d Sess. 18 (1934) (Section 10(b) supplements narrower antifraud prohibitions by extending to "any other manipulative or deceptive practices"). Congress intended the antifraud prohibition to fall with special force on " 'manipulative and deceptive practices which . . . fulfill no useful function' " and on " 'illicit practices,' where the defendant has not acted in good faith." *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 206. As Professor Loss has summarized, Section 10(b) was intended to serve as an "omnibus provision" to curtail all fraudulent schemes used in connection with securities trans-

actions. VI L. Loss, *Securities Regulation* 3528 (1969 ed.). Accord, 1 A. Bromberg, *Securities Law Fraud: SEC Rule 10b-5*, § 2.2(332) (1977). In light of the broad "catchall" purposes of Section 10(b) and Rule 10b-5, there is no basis for petitioner's argument that the unusual nature of the fraud that he practiced provides immunity from liability.

B. Petitioner Defrauded The Corporations That Entrusted Him With Confidential Information When He Secretly Converted That Information And Used It For Personal Profit In The Stock Market

Petitioner's secret conversion of confidential information operated as a fraud on the corporations that entrusted him with that information. Because he practiced his scheme to defraud through securities purchases and sales, he violated Section 10(b) and Rule 10b-5.

The indictment in this case charged that petitioner's actions operated as a fraud on the sellers of the securities. It also charged that his conduct amounted to a device, scheme, or artifice to defraud, without limitation on the category of victims (Indictment, ¶ 1). Accordingly, in its pretrial order denying petitioner's motion to dismiss the indictment, the district court explained that, if proven, the scheme charged in the indictment would operate as a fraud on the corporations whose information petitioner converted (Pet. App. B2-B3):

> Crediting the indictment, there is no question that Chiarella wrongfully took corporate information—unquestionably material and non-public

> —entrusted to him by offering corporations, and used it solely for personal profit, which information was "intended to be available only for a corporate purpose and not for the benefit of anyone." * * * The analogy of embezzlement by a bank employee immediately springs to mind, and, of course, embezzlement implies fraudulent conduct. *E.g., Grin* v. *Shine*, 187 U.S. 181, 189-90 * * * (1902). Chiarella can, therefore, hardly claim that the acts alleged did not operate as a fraud. * * * Chiarella's purchases further operated as a fraud upon the acquiring corporations whose plans and information he took while he was setting them in type, because his purchases might possibly have raised the price of the target companies' stock, increasing the cost of legitimate market purchases by such acquiring corporations, and thus constituted "a manipulative or deceptive device or contrivance" within the prohibition of § 10(b) and Rule 10b-5.

In light of the uncontradicted evidence of undisclosed misappropriation of confidential information presented at trial, the prosecutor argued to the jury that petitioner's conduct constituted a fraud against the acquiring companies (Tr. 605).[14]

The court of appeals agreed with the district court that petitioner's conduct operated as a fraud on the tender offerors as well as the sellers of securities (Pet. App. A13 n.14):

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[14] The district court's charge to the jury emphasized that Section 10(b) and Rule 10b-5 could be violated by a fraud practiced on "any person" in connection with a purchase or sale of securities (Tr. 681, 683, 686-687). This phrase, like Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), contains no limitation on the category of persons who may

> [T]he indictment fairly charges Chiarella violated Rule 10b-5 by converting offerors' confidential information to his own use. It not only alleged that appellant's activities "operated as a fraud and deceit upon the sellers of the aforementioned securities," it also charged a "scheme to defraud" in general terms. Clearly, violation of an agent's duty to respect client confidences, *Restatement (2d) Agency* § 395, transgresses Rule 10b-5, where, as here, the converted information both concerned securities and was used to purchase and sell securities.

The court also emphasized that petitioner's secret conversion and use of confidential information for market purchases threatened the offerors' interest in preventing an "anticipatory rise in the market price of the target company's stock" (*id.* at A3). As we demonstrate below, the district court and court of appeals correctly ruled that petitioner's conduct operated as a fraud on the acquiring corporations in violation of Section 10(b) and Rule 10b-5.

1. *Pre-announcement secrecy is essential to the success of tender offers*

As both of the courts below recognized, pre-announcement secrecy is essential to the success of a

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be victimized by a fraudulent scheme and reaches fraudulent practices aimed at businesses as well as individual investors. See *United States* v. *Naftalin*, *supra*, slip op. 6. Thus, the district court's charge permitted the jury to find that petitioner's conduct constituted a fraud upon both the acquiring companies and the investors who sold securities to petitioner.

tender offer or acquisition.[15] The corporations involved here used coded references in their draft prospectuses, or left the names of the target companies blank, to preserve strict confidentiality. Pandick Press recognized the importance of confidentiality by admonishing its employees that information contained in customer documents "is the private and personal property of the customer" and by prohibiting any disclosure or use of the information for private purposes (see pages 5-7, *supra*).

Members of the securities industry familiar with the mechanics of tender offers have frequently emphasized the need for pre-announcement secrecy. For example, during hearings before Congress prior to the enactment of the Williams Act, Pub. L. No. 90-439, 82 Stat. 454, witnesses pointed out that premature revelation of the acquiring company's plans can abort a tender offer. See, *e.g.*, testimony of Donald Calvin, Vice President of the New York Stock Exchange (*Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 72 (1967)):

> Obviously, a company intending to make a tender offer strives to keep its plan secret. If

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[15] A tender offer consists of a bid by an individual or a group to buy shares of a corporation, usually at a price above the current market price. This premium has the effect of raising the market price of the target company's stock once the tender offer becomes publicly known.

> word of the impending offer becomes public, the price of the stock will rise toward the expected tender price. Thus, the primary inducement to stockholders—an offer to purchase their shares at an attractive price above the market—is lost, and the offeror may be forced to abandon its plans or to raise the offer to a still higher price. The cost of an offer to purchase hundreds of thousands of shares might prove prohibitive if the price had to be increased only a few dollars per share. * * * In spite of all precautions, there have been cases where tender offers have been preceded by leaks and rumors which caused abnormal market problems.

See also *id.* at 73-75. Other witnesses also mentioned the necessity to avoid rumors and leaks of information about imminent tender offers. See *id.* at 84, 87-89 (remarks of Philip West, Vice President, and Keith Funston, President of the New York Stock Exchange); 98, 105 (remarks of Ralph Saul, President of the American Stock Exchange); 151, 163 (remarks of Francis Schanck, Vice President of the Investment Bankers Association). See also Hayes & Taussig, *Tactics of Cash Takeover Bids*, 45 Harv. Bus. Rev. 135, 139-140 (1967).

In addition to the potential effect on price, leaks and unusual trading patterns may alert the target company to the tender offeror's plans. See A. Fleischer, *Tender Offers: Defenses, Responses, and Planning* 4-6 (1978). A target company alerted to a possible tender offer by unusual trading volume or rumors can commence communications with its shareholders to deflect the offer, can prepare for litigation against

the offeror, and can attempt to find competing friendly bidders to defeat the offeror. See *id.* at 113-153. See also Hayes & Taussig, *supra*, 45 Harv. Bus. Rev. at 142-147; *Panel Discussion: Defending Target Companies*, 32 Bus. Law. 1349-1363 (special issue 1977). Of equally great importance, rumors, leaks and unusual trading patterns may alert the investment banking community and other potential tender offerors to the prospect of an attractive acquisition. This may trigger competing bids that result in expensive battles for control, if not total loss of the target company. See, *e.g.*, Troubh, *Purchased Affection: A Primer On Cash Tender Offers*, 54 Harv. Bus. Rev. 79, 83 (chart) (1976).

This "high drama of Wall Street," as the court of appeals observed, also has its "tedious aspects," particularly the vast amount of paper that must be generated before a tender offer is made (Pet. App. A2-A3). Therefore, to avoid unfavorable price behavior, defensive maneuvers by the target company, and competing bids, the tender offeror must select "[p]rinters * * * who are efficient as well as discreet * * *." Troubh, *supra*, 54 Harv. Bus. Rev. at 86. Far from being discreet, however, petitioner engaged in the very kind of behavior that was likely to frustrate the acquisition plans of Pandick's customers. As noted on pages 9-10, *supra*, petitioner's substantial trading in the stock of target companies represented one-half of the total volume of daily trading in two instances, and unexplained price rises in target shares were described by witnesses at trial. More-

over, petitioner's continuing communication with his broker and repeated purchases of large amounts of target company stock immediately prior to the announcement of the tender offers was the very kind of behavior that could serve as a tip to his broker and give rise to rumors of an offer.[16] This activity could easily have forewarned the target companies of the plans of the acquiring companies, to whom petitioner owed a duty of confidence.[17]

In sum, petitioner's secret conversion of confidential information and his use of that information for trading in the stock market placed him in a serious conflict of interest and posed a substantial threat to the interests of the customers of his printing firm.

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[16] Petitioner's broker was well aware that petitioner was employed in a financial printing firm (Tr. 70-74). The broker was also aware of petitioner's repeated success in picking tender offer targets immediately before the public announcement of the tender offers (Tr. 101-114). See generally *In re George Mayer*, Securities Exchange Act Release No. 84591 (1978) (customer trading alerts broker to non-public market information).

[17] See Fleischer, *supra*, at 4-5, pointing out that tender offer targets can protect themselves against take-over bids by "stock watch" programs focused on unusual trading activities and by alertness to information about possible tender offers available from brokerage houses. See also Reuben & Elden, *How To Be A Target Company*, 23 N.Y.L. Sch. L. Rev. 423, 429 (1978). Petitioner's use of confidential tender offer information was discovered by the New York Stock Exchange's stock watch personnel, who observed unusual trading patterns in the shares of one of the target companies. See *SEC* v. *Chiarella*, SEC Litigation Release No. 7935 (May 25, 1977).

2. *As an agent, petitioner was forbidden to engage in self-dealing affecting the subject matter of his agency without making full disclosure*

As a mark-up man at Pandick Press who received customer copy and who was aware of the need for confidentiality applicable to that copy, petitioner was subject to the rules of agency governing the preservation of confidences.[18] The rules of agency forbid an agent to place himself in a position of potential conflict with his principal, to earn secret profits through the agency, or to disclose or use for personal advantage any of the principal's confidential information. See II *Restatement of Agency* § 395 & Comments a and c, § 393 & Comment a, § 390 & Comment a, § 388, § 383 (1933). See also 1 F. Mechem, *Law of Agency* §§ 1189, 1191, 1209, 1224 (2d ed. 1914).

An agent contemplating a transaction that could infringe these rules has an unqualified duty to make prior disclosure to permit his principal to take steps to protect himself. See II *Restatement of Agency*, *supra*, at § 395 & Comment c, § 381 & Comment d, § 390 & Comment a, § 393 & Comment a. Accord, Mechem,

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[18] Because it assumed a fiduciary duty to use confidential information entrusted to it only for the purposes designated by its customers and acted under the control and for the benefit of those customers, Pandick Press occupied the position of an agent. See I *Restatement (Second) of Agency* § 14N (1958). Petitioner, an employee of Pandick Press with knowledge of the rule against using confidential information for personal benefit, was a sub-agent subject to identical fiduciary responsibilities. See Pet. App. A13 n.14; *id.* at A29 (Meskill, J., dissenting); II *Restatement of Agency* § 428 & Comment b; W. Seavey, *Agency* 10 (1964). See also Scott, *The Fiduciary Principle*, 37 Calif. L. Rev. 539, 540-541, 553-554 (1949); III J. Pomeroy, *Equity Jurisprudence* 793-796 (5th ed. 1941); 36A C.J.S. 382-389 (1961) (collecting cases).

supra, at §§ 1207, 1353. Nondisclosure by an agent or other fiduciary in such circumstances constitutes deceit. See, *e.g.*, III *Restatement of Torts* § 551(2)(a) & Comment e (1938); see also James & Gray, *Misrepresentation—Part II*, 37 Md. L. Rev. 488, 524-525 (1978); *Kerr on Fraud and Mistake* 185-186, 210-213 (7th ed. 1952); G. Bower, *The Law Relating to Actionable Non-Disclosure* 294-306 (1915).[19] Petitioner's contrivance to convert confidential information operated as a fraud on the companies that entrusted him with that information within these well-established principles.

3. *Petitioner's fraud occurred "in connection with" the purchase of securities and therefore violated the statute and the rule*

Because petitioner's scheme to defraud operated through his purchase of securities and also had a close

[19] This Court has frequently held that an agent's failure to disclose self-dealing or conflicts of interest constitutes fraud. See, *e.g.*, *Sim* v. *Edenborn*, 242 U.S. 131 (1916); *Strong* v. *Repide*, 213 U.S. 419, 428-433 (1909); *United States* v. *Carter*, 217 U.S. 286, 305-310 (1910); *Wardell* v. *Railroad Company*, 103 U.S. 651, 654-659 (1880). The common law rule in the state courts is the same. See, *e.g.*, *Holland* v. *Moreton*, 10 Utah 2d 390, 396, 353 P.2d 989, 994 (1960); *Myers* v. *Linebarger*, 134 Ark. 231, 234, 203 S.W. 580, 581 (1918); *Allen* v. *Barhoff*, 90 Conn. 184, 187, 96 A. 928, 930 (1916); *Ericson* v. *Nebraska-Iowa Farm Inv. Co.*, 134 Neb. 391, 399, 278 N.W. 841, 845 (1938); *Doyen* v. *Bauer*, 211 Minn. 140, 145-148, 300 N.W. 451, 454-456 (1941). Moreover, as the district court noted (Pet. App. B2-B3), petitioner's secret conversion of the intangible property of the customers of Pandick Press bears the indicia of embezzlement, a crime that is inherently fraudulent. See, *e.g.*, *Grin* v. *Shine*, 187 U.S. 181, 189 (1902); W. LaFave & A. Scott, *Criminal Law* 644-645 (1972).

relationship with (and potentially injurious effect upon) the securities purchases of the acquiring companies, his fraud occurred "in connection with" securities transactions. It therefore violated Section 10(b) and Rule 10b-5.[20] As noted above, Section 10(b) and Rule 10b-5 apply to "any" deceptive device or contrivance used in connection with a purchase or sale of securities. When a defendant employs deceptive practices "touching" the purchase or sale of securities, Section 10(b) and Rule 10b-5 are violated, regardless of the means used to achieve the fraud. *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971). As the *Bankers Life* case illustrates, concealed embezzlement or conversion, achieved through the vehicle of a securities transaction, constitutes a variety of fraud prohibited by Section 10(b) and Rule 10b-5. See *id.* at 10-11 & n.7 ("misappropriation is a 'garden variety' type of fraud"); see also *Allico National Corp.* v. *Amalgamated Meat Cutters & Butcher Workmen of North America*, 397 F.2d 727, 728-730 (7th Cir. 1968); A. Jacobs, *The Impact of Rule 10b-5* § 67.02 (1978); cf. *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 397 (2d Cir. 1967).[21]

[20] As noted above, petitioner's scheme would have been deemed fraudulent under common law principles. The securities laws impose even greater standards of candor, as this Court has often recognized. See, *e.g.*, *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194-195, 197-198, 201 (1963); *Affiliated Ute Citizens* v. *United States*, *supra*, 406 U.S. 128, 151 (1972). See also III L. Loss, *Securities Regulation* 1430-1436 (2d ed. 1961).

[21] See also *SEC* v. *Texas Gulf Sulphur Co.*, *supra*, 401 F.2d at 856 (self-dealing by agent officers of a corporation, who

Contrary to the assertion of the dissenting judge in the court below (Pet. App. A29), petitioner's secret conversion and use of confidential information was not merely a breach of fiduciary duty. Petitioner's conduct amounted to a breach of duty to be sure, but it also involved "some element of deception" (*Santa Fe Industries, Inc.* v. *Green, supra,* 430 U.S. at 475) —a material failure to disclose. And as this Court has noted, concealment, nondisclosure or deception in conjunction with a breach of fiduciary duty gives rise to a violation of Section 10(b) and Rule 10b-5. See *id.* at 474-476 & n.15. Finally, as the Court reaffirmed in *United States* v. *Naftalin, supra,* slip op. 6, the fact that this part of petitioner's fraudulent scheme was directed toward a business, rather than an investor, provides no immunity from prosecution, because the securities laws were intended to protect "honest business" as well as investors and thus to achieve " 'a high standard of business ethics . . . *in every facet of the securities industry*' " (emphasis in original).

C. Petitioner Defrauded Public Investors By Purchasing Securities From Them On The Basis Of Material Non-Public Information That He Converted From The Customers Of His Financial Printing Firm

Both courts below concluded that petitioner's purchase of securities based on material non-public information obtained by misappropriation constituted

purchase stock options from the corporation without revealing material facts, violates the statute and the rule); *id.* at 865 (Friendly, J., concurring).

fraud on the sellers of those securities in violation of Section 10(b) and Rule 10b-5 (Pet. App. A2-A15, B3). Petitioner contends, however, that he did not commit fraud because he was subject to no duty to disclose or abstain from trading. He asserts that the duty to abstain from trading prior to public disclosure applies only to "insiders" of the corporations that have issued securities, "tippees" of such insiders, or persons having a "special trustee type of relationship" with other traders in the market (Br. 17, 19, 20, 22). Petitioner claims, in substance, the privilege of the ancient rule of *caveat emptor.* As we demonstrate below, petitioner's claim ignores established principles of the law of deceit, recognized both at common law and under the federal securities laws.

1. *The rule of caveat emptor has never applied to transactions based on converted information that is inaccessible to other traders*

At common law, purchasers and sellers of goods were generally privileged to transact business with each other without disclosing their reasons for trading. See 2 T. Cooley, *Law of Torts* § 351, at 556 (4th ed. 1932): "*Caveat emptor* is the motto of commercial law, and in other dealings, as well as sales, every person is expected to look after his own interest, and is not at liberty to rely upon the other party to protect him against the consequences of his own blunders or heedlessness."[22] The rule of *caveat emptor* rewarded the astuteness of the informed trader and penalized

[22] See also II J. Kent, *Commentaries on American Law* 618-623 (7th ed. 1851); 12 *Williston on Contracts* §§ 1497-1499 (3d ed. 1970).

the heedlessness of the uninformed. Thus, "where the means of intelligence are equally accessible to both parties," a buyer was free at common law to purchase goods while in possession of material information bearing on the market for those goods, even if that information was unknown to the seller. *Laidlaw* v. *Organ*, 15 U.S. (2 Wheat.) 177, 195 (1817). Any other rule would penalize the "superior diligence and alertness" of the buyer, conduct that society should encourage rather than deter. See *id.* at 193.

But the purpose served by the rule of *caveat emptor* placed distinct limits on its scope. Thus, where (unlike in *Laidlaw*) the "means of intelligence" were not "equally accessible" to both traders, the common law decisions in certain commercial contexts imposed a duty of full disclosure. See, *e.g.*, 1 F. Harper & F. James, *The Law of Torts* § 7.14 at 588 (1956), describing the "salutary rule" requiring disclosure of facts "peculiarly and exclusively within the knowledge of one party to the transaction." [23] A duty of full disclosure applied at common law to those categories of commercial transactions in which one party had access to material information that was hidden from the other and good faith required candid dealing, as in

[23] See also, *Carter* v. *Boehm*, 3 Burr. 1905, 1910 (1766) (Mansfield, J.); *Hanson* v. *Edgerly*, 29 N. H. 343, 358-359 (1856); *Rothmiller* v. *Stein*, 143 N.Y. 581, 595, 38 N.E. 718, 722 (1894); *Jones* v. *Arnold*, 359 Mo. 161, 169, 221 S.W.2d 187, 193 (1940); *Simmons* v. *Evans*, 185 Tenn. 282, 285-287, 206 S.W.2d 295, 296-297 (1947); *Jenkins* v. *McCormack*, 184 Kan. 842, 844, 339 P.2d 8, 11 (1959); *Lingsch* v. *Savage*, 213 Cal.App.2d 729, 735-738, 29 Cal. Rptr. 201, 204-206, (1963); Cf. *Stewart* v. *Wyoming Ranche Co.*, 128 U.S. 383, 388 (1888).

certain insurance contracts, contracts of sale, suretyship contracts, and compositions. See G. Bower, *The Law Relating To Actionable Non-Disclosure*, *supra*, at 58-110; *Kerr on Fraud and Mistake*, *supra*, at 87.

A duty to disclose information inaccessible to the seller received unequivocal recognition when the buyer misappropriated or otherwise improperly came into possession of the information that formed the basis for the transaction. See, *e.g.*, G. Bower & A. Turner, *The Law of Actionable Misrepresentation* 107 (1974): "In other words, suppression by a purchaser of facts affecting the value of the property which are not merely within his own knowledge, but the issue of his own volition and wrongful action, is equivalent to a misrepresentation." This principle is illustrated by the English case of *Phillips* v. *Homfray*, L.R. 6 Ch. 770, 779-780 (1871), where the buyers converted coal from the sellers' property prior to purchasing the property: "the case is not merely that the purchasers, being more experienced men, knew the value of the coal better than the vendors, but that the vendors being unable to gain access to the coal, the purchasers took advantage of an unlawful access to it in order to test its value * * *." The court added that the buyer must employ a "legitimate mode of acquiring knowledge" if the rule of *caveat emptor* is to apply. *Ibid.* See also Keeton, *Fraud—Concealment and Non-Disclosure*, 15 Tex. L. Rev. 1, 25-26 (1936):

> [T]he way in which the buyer acquires the information which he conceals from the vendor should be a material circumstance. The infor-

> mation might have been acquired as the result of his bringing to bear a superior knowledge, intelligence, skill or technical judgment; it might have been acquired by chance; or it might have been acquired by means of some tortious action on his part. * * * Any time information is acquired by an illegal act it would seem that there should be a duty to disclose that information, irrespective of the nature of the remedy.

See also *id.* at 35; accord, 1 F. Harper & F. James, *supra*, § 7.14 at 590.[24]

Thus, the common law rule of *caveat emptor* affords no immunity to petitioner. The policy served by the rule—encouragement of diligence by sellers and buyers—has no application to conversion of information to secure an advantage over uninformed traders. Even under a strict view of the rule of *caveat emptor*, the law of fraud imposed a duty to speak when one party to a transaction had information inaccessible to the other, and that information was obtained through lawless means.

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[24] The economic basis for this rule of law is discussed at length in Kronman, *Mistake, Disclosure, Information, And The Law of Contracts*, 7 J. Legal Stud. 1, 9 (1978). As Prof. Kronman explains, the cases applying the rule of *caveat emptor* arise in a context where the party charged with nondisclosure has acquired information through legitimate research or other bona fide economic activity. The law permits nondisclosure in such contexts to encourage socially desirable economic behavior. See also *id.* at 34. But where a trading advantage is the result of exclusive access to important information, obtained and used in violation of an explicit legal duty, the rule of *caveat emptor* has no logical application.

2. The federal securities laws were intended to replace the doctrine of caveat emptor with that of full disclosure and to forbid misuse of confidential business information for personal enrichment in the stock market

If petitioner's claim of a right to trade without disclosure of misappropriated information finds little basis in common law precedent, it finds none under the federal securities laws. As this Court has repeatedly noted, "the 1934 Act and its companion legislative enactments embrace a 'fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*' * * *." *Affiliated Ute Citizens* v. *United States*, *supra*, 406 U.S. at 151 (footnote omitted); accord, *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963). Congress eliminated the rule of *caveat emptor* in securities transactions to restore investor confidence following the market crash of 1929.[25] Obtaining trading advantages over other investors through theft or

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[25] See, *e.g.*, H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934) ("If investor confidence is to come back to the benefit of exchanges and corporations alike, the law must advance. * * * Unless constant extension of the legal conception of a fiduciary relationship—a guarantee of 'straight shooting'—supports the constant extension of mutual confidence * * * easy liquidity of the resources in which wealth is invested is a danger * * *. Just in proportion as it becomes more liquid and complicated, an economic system must become more moderate, more honest, and more justifiably self-trusting"); S. Rep. No. 792, 73d Cong., 2d Sess. 3 (1934) ("The unfair methods of speculation employed by large operators and those possessing inside information regarding corporate affairs * * * have also been contributing causes of losses to investors").

conversion of confidential information is wholly inconsistent with the objectives Congress sought to achieve in 1934.[26] Those objectives were reaffirmed by Congress in 1975 when it amended the Securities Exchange Act of 1934, Pub. L. No. 94-29, 89 Stat. 97. See H.R. Conf. Rep. No. 94-229, 94th Cong. 1st Sess. 91-92 (1975):

> The basic goals of the Exchange Act remain salutatory and unchallenged: To provide fair and honest mechanisms for the pricing of securities, to assure that dealing in securities is fair and without undue preferences or advantages among investors * * * and to provide, to the maximum degree practicable, markets that are open and orderly.

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[26] See remarks of Rep. Wolverton, 78 Cong. Rec. 7865-7866 (1934) ("It is my hope and expectation that a wise and judicious administration of the provisions of this act will create a new confidence in the integrity of the security markets. * * * 'If there were a justifiable belief that security markets actually were "free and open", that all buyers and sellers met on substantially equal terms * * * the response would be a greater investment interest in securities and a consequent improvement in all phases of the security business.' "). Rep. Rayburn expressed similar views prior to the enactment of the Securities Act of 1933, 77 Cong. Rec. 2918 (1933) ("The purpose of this bill is to place the owners of securities on a parity, so far as is possible, with the management of the corporations, and to place the buyer on the same plane so far as available information is concerned, with the seller"). See also remarks of Rep. Rayburn, 78 Cong. Rec. 7697 (1934) ("We should have a market place for the exchange of securities, but it should be a clean and honest market place.").

In light of these statutory purposes, the Securities and Exchange Commission and the courts have repeatedly held that Section 10(b) and Rule 10b-5 prohibit corporate employees, officers and directors from taking personal advantage of material non-public information entrusted to them for business purposes. Such information must be made public before trading; if it cannot be made public, the possessor must abstain from trading. The analytic basis for this rule was summarized by the Commission in *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961) (emphasis supplied; footnote omitted):

> We have already noted that the anti-fraud provisions are phrased in terms of "any person" and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation. *Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing.*

The Commission's analysis parallels that of the common law decisions limiting the doctrine of *caveat emptor*: it is a sharp practice to reap profits by misappropriating non-public information and trading

on the basis of that information with persons lacking access to it.

The rule of *Cady, Roberts* has received the sanction of every court that has considered it.[27] See, *e.g.*, *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969):

> [Section 10(b) and Rule 10b-5 are] based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information * * *. The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone"

[27] The courts of appeals are unanimous in holding that trading on the basis of material inside information violates the statute and the rule. See *Kohler* v. *Kohler Co.*, 319 F.2d 634, 637-638 (7th Cir. 1963); *Mazel* v. *Fields*, 386 F.2d 718, 733-734 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); *Pennaluna & Co.* v. *SEC*, 410 F.2d 861, 869-870 (9th Cir. 1969), cert. denied, 396 U.S. 1007 (1970); *Stier* v. *Smith*, 473 F.2d 1205, 1208 (5th Cir. 1973). See also *Fridrich* v. *Bradford*, 542 F.2d 307, 318-322 & n.30, 323-327 & n.6 (6th Cir. 1976), emphasizing that criminal sanctions are available to enforce the prohibition. See generally III L. Loss, *Securities Regulation* 1445-1474 (2d ed. 1961); Schotland, *Unsafe At Any Price: A Reply To Manne, Insider Trading And The Stock Market*, 53 Va. L. Rev. 1425 (1967). The fact that other statutory provisions also extend to certain aspects of insider trading (see Section 16(b) of the Act, 15 U.S.C. 78p(b)) does not affect the coverage of Section 10(b). See *United States* v. *Naftalin*, *supra*, slip op. 9.

> may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public. * * * Insiders, as directors or management officers, are, of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an "insider" * * *.

This Court has also recognized that Section 10(b) and Rule 10b-5 forbid trading on the basis of material inside information. See *Foremost-McKesson, Inc.* v. *Provident Securities Co.*, 423 U.S. 232, 255 (1976), noting that "Congress has passed general antifraud statutes that proscribe fraudulent practices by insiders. * * * Today an investor who can show harm from the misuse of material inside information may have recourse, in particular, to § 10(b) and Rule 10b-5 * * *."

As both courts below recognized (Pet. App. A6-A8, B2-B3), there is no difference in principle between petitioner's conduct and that of an officer of an issuer corporation who trades on the basis of material nonpublic information.[28] Petitioner had access to confi-

[28] Contrary to petitioner's assertion (Br. 22), none of the foregoing cases limit the principles that they announce to a special category of persons. For example, tippees, with no special relationship with the issuing corporation and no "inside" status, are forbidden to utilize non-public information. See *In re Investors Management Co.*, 44 S.E.C. 633, 643 (1971) ("We reject the contentions advanced by respondents that no violation can be found unless it is shown that the recipient himself occupied a special relationship with the issuer or insider corporate source giving him access to non-

dential commercial information of great importance to investors, who could not have learned of it through any exercise of diligent research. He misappropriated that information for personal enrichment, in violation of his duty as an agent.[29] The conduct of a corporate officer, director or other agent of an issuer corporation, who misappropriates confidential information and exploits uninformed investors, is functionally identical. Although the source of the information is different, the elements are the same: (1) critical information is available to only one party to the transaction and (2) that information is converted rather than acquired through research or other bona fide economic activity.[30] Nor is the impact on the

public information * * *."). See also *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237-238 (2d Cir. 1974); *Kuehnert* v. *Texstar Corp.*, 412 F.2d 700, 702 (5th Cir. 1969). See generally A. Jacobs, *The Impact Of Rule 10b-5*, *supra*, § 66.02[a], at 3-273 to 3-278. As we discuss immediately below, these principles have been applied by the courts and the SEC in analogous cases involving market information frauds.

[29] Obtaining special trading advantages through misappropriation of confidential information is the very antithesis of obtaining a trading advantage through astute analysis of publicly available information, which the securities laws encourage. See *SEC* v. *Texas Gulf Sulphur Co.*, *supra*, 401 F.2d at 848-849. See also *In re Investors Management Co.*, *supra*, 44 S.E.C. at 641 n.18, distinguishing between information obtained by "general observation or analysis" and "industrial espionage."

[30] See *Diamond* v. *Oreamuno*, 24 N.Y.2d 494, 497-501, 248 N.E.2d 910, 912-914 (1969); *Brophy* v. *Cities Serv. Co.*, 31 Del. Ch. 241, 246, 70 A.2d 5, 8 (1949).

stock market different. As the court of appeals remarked (Pet. App. A15), "[i]t is difficult to imagine conduct less useful, or more destructive of public confidence in the integrity of our securities markets, than Chiarella's."[31] In short, the courts below correctly concluded that the mandate to "disclose or abstain" applied to petitioner. His trading on the basis of misappropriated information is a classic example of the kind of "deceptive practice[]" that can "fullfill no useful function." *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 206.[32]

3. *The fact that petitioner misappropriated non-public market information, rather than inside corporate information, does not immunize his conduct*

a. *Section 10(b) and Rule 10b-5 apply to petitioner's scheme even though the precise factual pattern involved here has not been presented in prior litigated cases*

Petitioner argues (Br. 20, 22) that the principles described above have no application to him because he was not an "insider" or a "tippee" of an insider,

[31] If, as petitioner suggests, the securities laws are not available to restrain or punish conduct such as his own, then other members of tender offer team might be encouraged to exploit material non-public information for personal gain. These persons include lawyers, accountants, bankers, corporate employees and secretaries. Highly profitable trading on the basis of such undisclosed information would scarcely be an isolated occurrence.

[32] Petitioner was, of course, forbidden to disclose the confidential information here in question. It was therefore incumbent upon him to await disclosure by the acquiring companies before commencing to trade for his own account. See *SEC* v. *Texas Gulf Sulphur Co.*, *supra*, 401 F. 2d at 848.

as described in *Cady, Roberts* and *Texas Gulf Sulphur*. But such a limiting interpretation cannot be squared with the literal text of Section 10(b), which applies to "any" fraudulent scheme, or with the legislative history of the statute, which shows that it was intended to be a "catchall" extending to all "new cunning devices." See pages 25-28, *supra*. As this Court noted in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, *supra*, 404 U.S. at 11 n.7 (quoting *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 397 (2d Cir. 1967) (emphasis in original)):

> "We believe that § 10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws."

Similarly, in *United States* v. *Naftalin*, *supra*, slip op. 3, this Court rejected the argument that the general antifraud provision in Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), should be limited to frauds of the kind involved in prior litigated cases—*i.e.*, frauds aimed at investors. The Court noted that "[n]othing on the face of the statute supports this reading of it" (slip op. 3).[33]

[33] Naftalin unsuccessfully argued in this Court that Section 17(a) should be limited to "investor" frauds in conformity with prior litigated cases: "in the entire history of Section 17(a) of the 1933 Act there existed 'no case in which [the statute] has been used to prosecute a defendant for fraud in the sale of securities perpetrated upon an agent-broker * * *'" (Br. 32).

In rejecting Naftalin's argument, the Court cited *United States* v. *Brown*, 555 F.2d 336 (2d Cir. 1977) (see slip op. 6), which held:

> The fact that there is no litigated fact pattern precisely in point may constitute a tribute to the cupidity and ingenuity of the malefactors but hardly provides an escape from the penal sanctions of the securities fraud provisions here involved.

Id. at 339-340. Nothing in Section 10(b) or Rule 10b-5 suggests that its prohibitions are confined to "insiders," "tippees" of insiders or "inside information." Frauds involving market information,[34] like any other frauds practiced in connection with a purchase or sale of securities, fall within the coverage of these broad antifraud provisions.[35]

Nor do economic considerations support petitioner's arguments about the scope of Section 10(b) and Rule 10b-5. The profits to be made from market information fraud, and the unfairness to investors, are at least as great as in inside information cases. Market information concerning forthcoming tender offers or acquisitions has tremendous importance to investors,

[34] In this brief, the term "market information" refers to information about the demand in the market for a particular security, as opposed to the value of the assets or earning power of the corporation that issues the security. See Pet. App. A8 n.8.

[35] Moreover, as we demonstrate on pages 56-61, *infra*, prior decisions of this Court and the lower federal courts have applied the "disclose or abstain" principle in market information cases that are analogous to the present case.

particularly in a period of increased tender offer activity. The price of a security at any given time depends on two things: the earning power and assets of the issuing corporation and the market demand for the security. The market may capitalize corporate earnings and assets at different levels, depending upon investor demand. Demand for securities reaches its apex during a tender offer, when the offeror agrees to pay a "premium" above the current market price. That premium can be quite substantial. A recent survey of tender offers occurring in 1975 and 1976 showed that the premium over the previous closing price for target company shares ranged from 22% to 66%. See Troubh, *supra*, 54 Harv. Bus. Rev. at 82.[36] Foreknowledge of a tender offer is *certain* knowledge that the shares owned by the seller are worth substantially more than he believes. Obtaining such knowledge by theft or other dishonest means in order to exploit a seller who is in ignorance of an impending tender offer is an act of deception and dishonesty properly forbidden by Section 10(b) and Rule 10b-5.

[36] See also Statistical Spotlight, *Forbes*, Feb. 9, 1979 at 69 (analysis of 40 largest takeovers in 1978 showed premiums of 40% or more to be common, with premiums of over 100% in some cases). As noted in Borden & Weiner, *An Investment Decision Analysis of Cash Tender Offer Disclosure*, 23 N.Y. L.Sch. L. Rev. 553, 575-576 (1978), from the point of view of the offeree, "price is * * * the name of the game." Where there is a reasonable premium, "investors almost always sell."

b. *The statutory context shows that Section 10(b) applies to all frauds, including market information frauds*

The structure of the Securities Exchange Act of 1934 supports the view that Section 10(b) should extend to all fraudulent schemes, including those involving market information. Section 10(b) stands between Sections 9 and 11 of the Act; the three provisions may be viewed *in pari materia*. See VI Loss, *supra*, at 3528. See also *SEC* v. *National Securities, Inc.*, 393 U.S. 453, 466 (1969) ("the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen * * *").

Section 11(b) of the Act, 15 U.S.C. 78k(b), places strict limitations on securities exchange specialists who possess non-public market information. Those limitations prevent tipping of market information and discretionary trading for customers on the basis of such information:

> It shall be unlawful for a specialist or an official of the exchange to disclose information in regard to orders placed with such specialist which is not available to all members of the exchange, to any person other than an official of the exchange, a representative of the Commission, or a specialist who may be acting for such specialist * * *. It shall also be unlawful for a specialist permitted to act as a broker and dealer to effect on the exchange as broker any transaction except upon a market or limited price order.

The specialist's market-making role necessitates his own purchases and sales of securities to promote continuous and orderly price movements. But Congress prohibited misuse of the market information entrusted to him: "The specialist is forbidden to reveal the orders on his books to favored persons. This information must be available to all members or else kept entirely confidential. The specialist is likewise prohibited from exercising purely discretionary orders as distinct from market or limited price orders." S. Rep. No. 792, 73d Cong., 2d Sess. 18 (1934); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 22 (1934). See also S. Rep. No. 1455, 73d Cong., 2d Sess. 25-30 (1934). During debates on Section 11(b), Congress focused on the unfairness inherent in permitting certain traders to utilize non-public market information for personal gain:

> [I]s there not a danger that a few men on the inside, the officers of the exchange, may secure from the specialist in advance any and all information they desire, precisely as they have heretofore?
>
> Will they not still be able to obtain information that will apprise them in advance of all the other members of the exchange knowledge of the accumulated overnight orders to buy or sell various stocks, the amount and the prices at which the sellers will sell, and the prices at which buyers are willing to buy? * * * Armed with this confidential information, they would be able easily to decide what course to pursue as between buying or selling. Or, in other words, * * * they would have the opportunity of looking into all the other players' hands, and then of making their bets at this gambling table in safety not only to the disadvantage of outside investors but even to the [dis]advantage of their fellow members of the gambling fraternity as well. It is practically the same as if they were playing with marked cards.

78 Cong. Rec. 8031-8032 (1934) (remarks of Rep. Sabath). These concerns led to the adoption of the restrictions on specialist activities contained in Section 11(b).

Like Section 11(b), Section 9(a)(1) of the Act, 15 U.S.C. 78i(a)(1), seeks to prevent market information frauds. That provision prohibits, *inter alia*, manipulative securities transactions that have

> * * * the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security * * *.

Market manipulation, in the view of Congress, effectively defrauds public investors by misleading them about current market facts. See S. Rep. No. 1455, 73d Cong., 2d Sess. 32 (1934) ("In all cases fictitious activity is intentionally created, and the purchaser is deceived by an appearance of genuine demand for the security"); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 10 (1934).

Viewing Section 10(b) in this statutory context thus fortifies the conclusion that it applies to all

fraudulent schemes, including those involving market information. Congress recognized the danger to investors from market information frauds and attempted to minimize that danger in Sections 9 and 11 of the Act. Section 10(b), the catchall provision inserted between Sections 9 and 11 to deal with any new cunning devices, should be construed in accordance with that recognition. In the view of Congress, misuse of market information is a deceptive device or contrivance—in the words of Representative Sabath, it is the same as "playing with marked cards."

c. *This Court and the lower federal courts have applied Section 10(b) and Rule 10b-5 to market information frauds*

This Court's decision in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 144-154 (1972), confirms that Section 10(b) and Rule 10b-5 can apply to trading by persons, not insiders or tippees of insiders, possessing material non-public market information. The defendants in *Ute* purchased shares in their individual capacities directly from the plaintiffs and arranged for the sale of shares to third parties, effectively serving as market makers in the securities in question. They failed to disclose to the sellers at the time of purchase that the current market value of the stock on the resale market was far higher than the sellers believed. The Court held that this failure to disclose market information constituted a violation of the statute and the rule, noting that "[t]he sellers had the right to know that the defendants were in a position to gain financially from their sales and that

their shares were selling for a higher price in that market." 406 U.S. at 153.[37]

Petitioner's situation is the same as that of the defendants in *Ute*. He purchased securities while in possession of unquestionably material market information that was unknown, and could not have been known, to the sellers. Although the defendants in *Ute* had a special relationship with the sellers by virtue of their market-making role, petitioner's position imposed on him similar if not more exacting responsibilities. His professional duties placed him near the center of major market-shaping events. It was his job to maintain the confidentiality of critically important information that would create substantial preferences and unfairness in the marketplace if leaked or selectively revealed. It was also his job to help prepare documents that he knew were to be publicly disclosed to all investors on an equal basis. As the court of appeals observed, a "financial printer] * * * [is] a central, though generally unheralded, cog in the vital machinery for disseminating infor-

[37] The Court rejected the defendants' contention that they could not be guilty of fraud because they merely stood "mute": "We do not read Rule 10b-5 so restrictively. To be sure, the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted. These defendants' activities * * * disclose, within the very language of one or the other of these subparagraphs, a 'course of business' or a 'device, scheme or artifice' that operated as a fraud upon the Indian sellers." 406 U.S. at 152-153. Accord, *SEC* v. *Capital Gains Research Bureau, Inc., supra*, 375 U.S. at 197-198.

mation to investors" (Pet. App. A7). Petitioner perverted that function by misappropriating the information entrusted to him and exploiting uninformed investors. Since, as *Ute* emphasizes, the securities laws were intended to preserve "a high standard of business ethics" in all aspects of the securities industry (406 U.S. at 151), petitioner may not contend that his role in the securities market was any less "special" or required less "trust" than that of the defendants in *Ute*.[38]

The lower courts have also held that fraudulent practices involving market information violate Section 10(b) and Rule 10b-5. The facts in *SEC* v. *Shapiro*, 494 F.2d 1301, 1303-1307 (2d Cir. 1974), for example, bear a striking resemblance to those presented here. The defendants in *Shapiro* were consultants who assisted an acquiring company in its efforts to merge with a target company. Aware of the impending merger, the consultants purchased shares in the target company for themselves, selling them at a large profit after public announcement of the merger

[38] Petitioner also argues (Br. 33) that *Ute* is inapplicable here because it recognized that "transfer agents" would not ordinarily be required to make disclosure to investors. But transfer agents normally do not purchase securities; they merely record transfers of securities on the books of issuer corporations. Unlike a transfer agent, petitioner purchased large quantities of securities for himself at a substantial personal profit (see Pet. App. A4 n.3). And, in contrast to an ordinary transfer agent, petitioner was entrusted with highly confidential information, which he misused in violation of the rules of his employer and in breach of his duty to his employer's customers.

plan. The court of appeals concluded that this misuse of material non-public information for personal enrichment violated the statute and the rule.[39] In sum, the application of Section 10(b) and Rule 10b-5 to market information frauds has substantial judicial precedent; it is the materiality of the nonpublic information, not its source, that is relevant under the statute and the rule.

d. *The Securities and Exchange Commission has applied Section 10(b) and Rule 10b-5 to various kinds of market information frauds*

For over 30 years, the Securities and Exchange Commission has brought enforcement proceedings in cases involving market information frauds. See, *e.g.*, *In re Herbert L. Honohan*, 13 S.E.C. 754 (1943) (misappropriation of information about sealed bids to learn market facts inaccessible to other persons); *In re Blyth & Co.*, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,647 (1969) (use of material non-public information about interest rates affecting market conditions wrongfully ob-

[39] See also *Zweig* v. *Hearst Corporation*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,851, at 95,460-95,462 (9th Cir. 1979) (market information fraud by financial columnist); *Courtland* v. *Walston & Co.*, 340 F. Supp. 1076, 1082-1084 (S.D. N.Y. 1972) (market information fraud by broker). See generally Jacobs, *The Impact of Rule 10b-5*, *supra*, § 66.02[b], at 3-289 to 3-292. These decisions support the proposition announced by the Second Circuit over 30 years ago: "The essential objective of securities legislation is to protect those who do not know market conditions from the over-reachings of those who do." *Charles Hughes & Co.* v. *SEC*, 139 F.2d 434, 437 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944).

tained from a Treasury Department employee). See also *SEC* v. *Hancock*, SEC Litigation Release No. 505 (Mar. 18, 1949), condemning a scheme to misappropriate information for personal trading advantages. In *Hancock*, an employee of an investment company relayed information about planned securities purchases by the company to a broker, who purchased the shares cheaply and subsequently resold them to the company at a profit. This scheme to defraud, involving market information, was the basis for a subsequent criminal indictment. See *United States* v. *Hancock*, SEC Litigation Release No. 530 (Aug. 8, 1949).

The Commission has also brought a number of enforcement proceedings under Section 10(b) and Rule 10b-5 when confidential market information concerning forthcoming corporate acquisitions is misappropriated and used in the public securities markets. See, *e.g.*, the consent decrees in *SEC* v. *Sorg Printing Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,767 (S.D.N.Y. 1974); *SEC* v. *Primar Typographers, Inc.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,734 (S.D.N.Y. 1976); *SEC* v. *Ayoub*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,567 (S.D.N.Y. 1976); *SEC* v. *Manderano*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,357 (D.N.J. 1978). Enforcement actions have also been commenced against executives of acquiring companies who purchased shares of target company stock prior to public revelation of a tender offer. See, *e.g.*, *SEC* v. *Rosenberg*, [1974-1975

Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,766 (S.D.N.Y. 1974); *SEC* v. *Healy*, SEC Litigation Release No. 6589 (S.D.N.Y. 1974); *SEC* v. *Stone*, SEC Litigation Release No. 8527 (S.D.N.Y. 1978). See also *FTC* v. *Mandel Brothers, Inc.*, 359 U.S. 385, 391 (1959) (administrative interpretation entitled to deference "even though it was applied in cases settled by consent").

Thus, application of Section 10(b) and Rule 10b-5 to market information frauds finds substantial support in the enforcement actions of the administrative agency vested with primary responsibility for interpreting the Securities Exchange Act of 1934.

e. *Petitioner's proposed limitation of the statute and the rule would lead to absurd results*

The limiting interpretation of Section 10(b) and Rule 10b-5 that petitioner urges would result in illogical legal standards. The essence of petitioner's claim is that persons such as himself who have no relationship with the issuing corporation and who obtain non-public information solely from the acquiring corporation may freely use that information in the stock market. This is so, petitioner argues, because they do not obtain their information from traditional inside sources and have no express fiduciary relationship with the issuing corporation or other traders in the market (Br. 19, 20, 22).

If petitioner's contention were adopted, it would mean that an officer or director of a tender offeror could purchase large quantities of target company stock for his own account after emerging from a

meeting at which plans to make a tender offer had been approved. However, if, instead of a tender offer, the acquisition was a negotiated corporate merger, and the same acquiring company officer or director learned of the acquisition from attending a confidential meeting also attended by the target company's officers, his information would be "inside." His source would be the "issuer corporation" and, under petitioner's analysis, the employee would be forbidden to purchase shares in the target company.[40] Despite the fact that confidential corporate information is misappropriated in both cases for the purpose of exploiting uninformed investors, petitioner's proposed rule of law would impose liability in one instance but not the other.

The same anomaly would arise in the case of printers. Under petitioner's proposed rule, printers who convert non-public information from tender offerors may freely purchase securities in the target company at the expense of uninformed investors. But if a printer obtains his information by reviewing confidential merger documents submitted by the target company rather than the acquiring company, then, under petitioner's theory, he is forbidden to trade.

These examples expose the arbitrariness of petitioner's proposed legal standard. Indeed, the only

[40] As petitioners' argument recognizes, when confidential market information concerning a forthcoming acquisition stems from the issuer corporation, Section 10(b) and Rule 10b-5 clearly prohibit tipping and use of that information for personal trading. See, *e.g.*, *SEC* v. *Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976).

discernible logic of petitioner's standard is that it excludes *him* from liability. Under the established principles of fraud that we have discussed above, each of the traders in the preceding examples has violated Section 10(b) and Rule 10b-5. Each has misappropriated confidential corporate information in violation of his duty as an agent and each has used that information to exploit uninformed investors in the purchase or sale of securities. As the court of appeals recognized (Pet. App. A13-A15), conversion of confidential information for the purpose of obtaining an advantage over other investors undermines public confidence in the national securities markets and conflicts with the congressional purpose to eliminate all frauds in securities transactions. This is true regardless of the formal relationship between the buyer and seller or the source of the non-public information that is used for personal enrichment at the expense of other traders.

4. *Petitioner's conversion of market information for the purpose of exploiting uninformed investors bears no resemblance to the actions of business firms engaged in bona fide economic activity*

Petitioner contends (Br. 25-29) that his conduct is "identical" to that of tender offerors who, prior to publicly announcing their acquisition plans, may purchase up to 5% of the stock of target companies on the open market.[41] He also argues that if he is subject

[41] Under the Williams Act amendments to the Securities Exchange Act, 15 U.S.C. 78m(d), 78n(d), an acquiring firm, including a tender offeror, must disclose various facts about itself and its acquisition plans after it acquires 5% of any

to liability, then bona fide activities of businesses such as "specialists," "block positioners," and "arbitrageurs" likewise "would be subject to Rule 10b-5 liability" (Br. 34). The court below correctly concluded (Pet. App. A10-A15) that there is no substance to these comparisons and no reason to extrapolate rules of liability appropriate in this case to other situations presenting different questions of fact and public policy.

The facts in this case do not show simple possession of non-public market information generated by bona fide economic activity. As the court of appeals noted, the undisputed evidence at trial proved that petitioner "converted" information from the customers of Pandick Press for personal enrichment in the stock market (Pet. App. A13); the district court described his conduct as a form of "embezzlement" (*id.* at B2). The common law of fraud, as we have discussed on pages 39-42, *supra*, drew a clear distinction between use of information obtained by misappropriation and bona fide economic activity. See Keeton, *supra*, 15 Tex. L. Rev. at 25-26, 35; Bower & Turner, *supra*, at 107; Kronman, *supra*, at 9, 13-18, 33-34. By the same token the antifraud provisions of the federal securities laws are aimed at " 'manipulative and deceptive practices which . . . fulfill no useful function' " (*Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S.

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class of stock of the issuer. As originally enacted, these provisions required disclosure when 10% of the target company's stock had been acquired; the figure was lowered to 5% in 1970.

at 206), not at bona fide business activity.[42] In these circumstances, there is no basis for the assertion that petitioner's conduct should be immunized under legal principles that have been applied to legitimate forms of commercial activity or that affirmance of the decision below would cast doubt on the propriety of those activities.

Petitioner's contention that his conversion of confidential information for personal trading is "identical" with the actions of tender offerors totally ignores the nature of the commercial operations in which tender offerors engage and the regulatory framework that surrounds them. Tender offerors participate in bona fide economic activity within a pervasive scheme of regulation that accommodates their legitimate interests with those of the investing public.

To protect the interests of both investors and tender offerors, the Williams Act does not require the filing of disclosure documents until a tender offer is "first published, or sent or given to security holders." 15 U.S.C. 78n(d)(1). Prior to the commencement of the tender offer, disclosure is not required unless the acquiring company obtains 5% of any class of the

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[42] Congress intended the securities laws to protect the investing public with the least interference to honest business. See, *e.g.*, remarks of Rep. Wolverton, 78 Cong. Rec. 7863 (1934) ("The uppermost thought that has dominated our individual and collective decisions has been a desire to correct existing evils, or conditions that have proved harmful, without destroying, curtailing, or handicapping legitimate business."). Accord, remarks of Rep. Chapman, *id.* at 7925; remarks of Rep. Rayburn, *id.* at 8013.

target company's securities. See 15 U.S.C. 78m(d)(1). Thus, premature disclosure, which could frustrate market-testing by a potential tender offeror, is not compelled. This reflects a careful congressional balancing. As Senator Williams stated prior to enactment of the Williams Act: "I have taken extreme care with this legislation to balance the scales equally to protect the legitimate interests of the corporation, management, and shareholders without unduly impeding cash takeover bids." 113 Cong. Rec. 854 (1967). See also S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967); *Rondeau* v. *Mosinee Paper Corp.*, 422 U.S. 49, 58-59 (1975).[43]

This congressional balancing of interests has no application to petitioner's case, as the courts below correctly held.[44] Congress has expressed no policy

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[43] Senator Williams also pointed out: "Substantial open market or privately negotiated purchases of shares may precede or accompany a tender offer or may otherwise relate to shifts in control of which investors should be aware. While some people might say that this information should be filed before the securities are acquired, disclosure after the transaction avoids upsetting the free and open auction market where buyer and seller normally do not disclose the extent of their interest * * *." 113 Cong. Rec. 856 (1967). As this indicates, there is normally no requirement that a person advise the market of the amount of stock he is planning to buy or sell. But where investment decisions are based on information concerning forthcoming tender offers that is converted or embezzled, entirely different considerations are presented.

[44] The SEC has recently proposed a rule (SEC Rule 14e-2(c)) under the Williams Act that would bar trading by the tender offeror in the target company's securities once it "has determined to make a tender offer," unless public disclosure of its intentions is made. The proposed rule would afford additional protection to public investors. This proposal is based on the premise that the tender offeror should be permitted to "test the market" only so long as it is still undecided about whether to make an offer. Proposed Rule 14e-2(a) would also specify that persons other than the tender offeror (including persons such as "warehousers") may not trade on the basis of confidential information concerning the offer. See 44 Fed. Reg. 9956, 9976-9978 (1979). Proposal of these specific rules does not imply that the conduct they cover was previously immune from regulation under other, more general, statutory provisions or rules or that fraud occurring in the course of that conduct would not violate Section 10(b) and Rule 10b-5 if practiced in connection with a securities purchase or sale. See generally *SEC* v. *National Securities, Inc.*, *supra*, 393 U.S. at 468; *United States* v. *Naftalin*, *supra*, slip op. 9; see also *Electronic Specialty Co.* v. *International Controls Corp.*, 409 F.2d 937, 940-941 (2d Cir. 1969).

judgment in favor of his dishonest scheme. Petitioner engaged in no bona fide economic activity that justifies trading prior to public disclosure. Unlike a tender offeror, which ordinarily undertakes an acquisition program based on independent analysis and economic planning and which assumes the risks of the investment process, petitioner converted information not publicly available and used that information to bet on a sure thing. Unlike tender offerors, who must disclose their plans and actions at the time prescribed by Congress under the Williams Act, petitioner did not make any disclosure to anyone. And unlike the activities of tender offerors which can promote investor welfare (see *Rondeau* v. *Mosinee Paper Corp.*, *supra*, 422 U.S. at 58 n.8), petitioner's actions served

only to injure other investors and the tender offerors whose confidence he betrayed.

General Time Corp. v. *Talley Industries, Inc.*, 403 F.2d 159, 164-165 (2d Cir. 1968), relied on by petitioner, offers no support to his position. *General Time* held that an acquiring company need not disclose its acquisition plans prior to making certain open market purchases. The court observed that, at least in the initial stages of the acquisition, requiring the purchaser to make a public announcement of his plans could easily result in anticipatory price increases and thus "abort" the acquisition. Nothing in *General Time* suggests that persons who trade on the basis of information converted from acquiring companies have a privilege to enrich themselves. The court's concern for the effectiveness of the tender offer and the need to preserve pre-announcement secrecy confirm that its reasoning would not condone a scheme of the kind involved here, which had the clear potential to frustrate bona fide tender offers (see Pet. App. A13; see also pages 34-35, *supra*).[45]

The case of the specialist is similar to that of the tender offeror. As noted on pages 53-55, *supra*, Congress recognized that specialists who make a market in securities while in possession of information about prevailing public demand for those securities con-

[45] See A. Jacobs, *supra*, § 66.02[b], at 3-284 (footnote omitted), noting that the rule in *General Time* has no application to persons in petitioner's position: "[T]his [rule] cannot justify purchases by persons who know the tenderor's plans. Trading by persons having this informational inequity is contrary to the Rule's policies."

tribute to the stability of prices on the national securities exchanges. The Act expressly authorizes the registration of specialists to serve as market makers. See Section 11(b) of the Act, 15 U.S.C. 78k(b). As discussed above (see page 54, *supra*), Section 11(b) balances the legitimate interests of the specialist and the investing public. Specialists are prohibited from selectively tipping other traders or placing discretionary orders for preferred customers on the basis of non-public market information contained in their books. Due to their essential role in the market, however, they are not altogether forbidden to trade while in possession of market information.[46]

The fact that businesses may ordinarily engage in specialist activities, open market purchases, arbitrage or block trading (within statutory and regulatory restrictions) without disclosing information generated by *their own* activities does not immunize petitioner's conduct. Unlike these businesses and

[46] Other participants in the securities markets, such as block traders, arbitrageurs, bank trust departments, mutual funds, and insurance companies, also may possess information about impending changes in market conditions due to their ability to buy and sell large quantities of stock. Congress recognized that large transactions by such institutions may have some impact on market price, but it acknowledged that such transactions are a necessary part of the operation of the national securities markets. See H.R. Rep. No. 1383, 73d Cong., 2d Sess. 20 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 17 (1934). See also Section 11(a)(1)(A)-(D) of the Act, 15 U.S.C. 78k(a)(1)(A)-(D).

ordinary investors participating in the nation's securities market, petitioner converted confidential market information of another person intended for a special commercial purpose.[47] As explained in the brief *amicus curiae* of the Securities Industry Association (page 30),[48] there is no reason why imposition of

[47] Petitioner's conversion of confidential information to secure an advantage over uninformed traders in the public securities markets is totally unlike the bona fide research activities of investors, brokers and stock market analysts who achieve superior insights through investigation of publicly available information. See note 29, *supra*.

[48] We agree with the contention of the brief *amicus curiae* that certain language in the opinion of the court of appeals, taken out of context, incorrectly suggests that mere possession or regular receipt of confidential market information precludes market professionals (such as market makers, specialists, arbitrageurs, and block traders) from carrying on their normal business activities. Each of these businesses purchases and sells securities as a necessary part of its operations and possesses from time to time confidential information about market conditions that is generated by its own bona fide commercial activity. We do not understand the opinion of the court of appeals, viewed in its entirety, to question the propriety of these business operations. Significantly, the court was careful to point out: "We are not to be understood as holding that no one may trade on nonpublic market information without incurring a duty to disclose" (Pet. App. A10). In this connection, the court referred to the case of tender offerors, which may possess market information generated by their own legitimate activities. Thus, while we agree with the court of appeals that Section 10(b) and Rule 10b-5 apply to theft or misappropriation of confidential information for personal use in the stock market by both traditional corporate insiders and market insiders such as petitioner, we also agree with *amicus* that Section 10(b) and Rule 10b-5 would not ordinarily prohibit market professionals from

liability on agents who fraudently misappropriate confidential information for personal enrichment should establish a precedent applicable in areas of legitimate business activity.[49]

carrying on their securities business while in possession of confidential information stemming from their own legitimate business operations. That is not to say, however, that the activities of such professionals may never violate the statute and the rule. If, for example, a block trader, arbitrageur, or portfolio manager received a tip from a printer and realized that he was obtaining converted information about an impending tender offer, subsequent trading on the basis of that information would violate Section 10(b) and Rule 10b-5.

We do not agree with the assertion of *amicus* that the SEC is required to proceed by rule-making in developing standards to govern the use of market information by securities industry professionals. To be sure, detailed rules may prove to be workable in some areas. But as Professor Loss has pointed out, an appropriate standard of conduct applicable in different contexts does not readily "lend itself to definition." ALI, *Federal Securities Code* § 1603, at 538-539 (Proposed Official Draft 1978). Professor Loss notes that new and "egregious" forms of fraud involving market information are properly dealt with under general antifraud provisions, adding that "this area must be left to further judicial development." *Ibid.* Particularized rules for different commercial contexts are, of course, desirable when feasible, but the decision whether to proceed by rule-making or adjudication remains a question committed to administrative discretion. *SEC* v. *Chenery Corp.*, 332 U.S. 194, 201-203 (1947); *NLRB* v. *Bell Aerospace Co.*, 416 U.S. 267, 290-295 (1974). In any event, that question is not presented in this case.

[49] The brief *amicus curiae* correctly notes (Br. 30) that "liability under Rule 10b-5 may be predicated upon the deliberate, and purely personal, utilization of market information, where the information was received solely by virtue of a confidential business relationship, and where there is a clear

In summary, this case involves only the narrow question whether Section 10(b) and Rule 10b-5 prohibit the unlawful conversion and use of market information not available to the general public in an effort to exploit uninformed investors. Petitioner's trading on undisclosed information cannot be analogized to bona fide commercial activity. As the court of appeals concluded, the law properly distinguishes between petitioner's conduct and that of the tender offerors, specialists, and block traders to whom he would compare himself.

II. SECTION 10(b) AND RULE 10b-5 AND THEIR RELEVANT INTERPRETATIONS PROVIDED FAIR NOTICE THAT PETITIONER'S CONDUCT WAS UNLAWFUL

Petitioner contends (Br. 38-48), that he was denied "fair notice" that his conduct violated Section 10(b) and Rule 10b-5. He argues that the legal basis for his prosecution was so obscure that, even had he consulted an attorney, he would not have learned that his actions entailed a substantial risk of criminal liability (Br. 38, 41, 48).

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showing 'that an expectation of fair dealing . . . is justified.'" See also Fleischer, Mundheim & Murphy, *An Initial Inquiry Into The Responsibility To Disclose Market Information*, 121 U. Pa. L. Rev. 798, 822 (1973): "[I]t may be realistic to expect that a market professional who is given a preferred position in order to fulfill a particular market function will use any confidential information received as a consequence of his position solely to further his assigned role." Accord, Comment, *The Application of Rule 10b-5 to "Market Insiders": United States* v. *Chiarella*, 92 Harv. L. Rev. 1538, 1547 (1979).

1. Petitioner's argument ignores the fact that the statute and rule prohibit all fraudulent schemes. They provide the clearest possible warning that any deceptive device or contrivance, scheme or artifice to defraud, or course of business that operates or would operate as a fraud on any person is unlawful.[50] The scope of these provisions is unequivocal: every scheme to defraud is forbidden if practiced in connection with a purchase or sale of securities and through use of the prescribed jurisdictional means.

Prior to petitioner's actions, this Court had confirmed that Section 10(b) and Rule 10b-5 prohibit fraudulent misappropriations practiced in connection with securities transactions (*Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, *supra*); the lower courts had uniformly held that trading on the basis of inside corporate information was illegal (*SEC* v. *Texas Gulf Sulphur Co.*, *supra*); and this Court had held that failure to disclose market information could constitute a fraud under the statute (*Affiliated Ute Citizens* v. *United States*, *supra*). Before petitioner acted, the Second Circuit also held that persons aware of corporate acquisition plans

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[50] See *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808, 832 (D. Del. 1951):

> In enacting the section, Congress sought to eliminate, within the sphere of federal jurisdiction, all deceptive devices or contrivances. * * * As stated by Judge Cardozo [in *People* v. *Mancuso*, 255 N.Y. 463] "one is at a loss to imagine how" this broad objective "could be more accurately stated, without a catalogue of particulars not susceptible of enumeration in advance of the event."

could not purchase shares in the target company prior to public disclosure (*SEC* v. *Shapiro*, *supra*). Moreover, the Securities and Exchange Commission had commenced judicial and administrative proceedings based on market information frauds and had filed complaints against printers under Section 10(b) and Rule 10b-5 when they traded on the basis of non-public tender offer news. See pages 59-61, *supra*. Thus, the agency charged with the interpretation and enforcement of the Act had expressed its view that petitioner's conduct could give rise to a violation (*SEC* v. *Sorg Printing Co.*, *supra*).[51]

The Securities Exchange Act of 1934 expressly authorizes criminal prosecutions for willful violations of its provisions and the rules promulgated thereunder. See 15 U.S.C. 78ff.[52] Before petitioner undertook his scheme to defraud, numerous criminal prosecutions had been commenced by the Department of

[51] Of course, petitioner was also on warning that the statute and rule would receive a broad and flexible interpretation. See *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, *supra*, 404 U.S. at 12; 1 Bromberg, *supra*, at § 2.2(332).

[52] This case involves a prosecution under a statute defining a specific federal offense. Although, as the dissenting judge noted in the court below (Pet. App. A33), this Court's recent decisions have restricted the availability of "implied remedies," the Court has not hesitated to give full scope to criminal enforcement proceedings expressly authorized by Congress. *United States* v. *Naftalin*, *supra*. Limitation of implied private remedies, which serve as supplements to government enforcement proceedings, gives added importance to the efforts of the Department of Justice and the Securities and Exchange Commission to obtain compliance with the statute.

Justice under Section 10(b) and Rule 10b-5 where willful violations were found to exist, including, as noted on page 60, *supra*, a case involving a market information fraud.[53]

If petitioner or an attorney consulted by him had made even a minimal effort to ascertain the requirements of the law, they would have learned that petitioner's intended conduct entailed a substantial risk of criminal liability. "No honest and reasonable citizen could have difficulty in understanding" the illegality of that course of conduct. See *United States* v. *Persky*, 520 F.2d 283, 286-288 (2d Cir. 1975), rejecting a similar "fair notice" claim under Section 10(b) and Rule 10b-5. The argument that no "omens" or "portents" of liability were present (Br. 41) ignores the broad prohibitory language of the statute and rule and the line of authority that we have summarized above. Simply stated, a person of ordinary intelligence had fair notice that the decep-

[53] See, *e.g.*, *United States* v. *Re*, 336 F.2d 306 (2d Cir.), cert. denied, 379 U.S. 904 (1964) (market manipulation); *United States* v. *D'Honau*, 459 F.2d 73 (9th Cir. 1972) (market manipulation); *United States* v. *Koss*, 506 F.2d 1103 (2d Cir. 1974) (failure to deposit proceeds of offering); *United States* v. *Persky*, 520 F.2d 283 (2d Cir. 1975) (false press releases); *United States* v. *Wolfson*, 289 F. Supp. 903 (S.D. N.Y. 1968) (fraudulent distribution of securities). Many other criminal indictments under Section 10(b) and Rule 10b-5 have resulted in convictions without published opinions. Some of those indictments are described in III Loss, *Securities Regulation*, *supra*, at 1449 n.15; VI Loss, *Securities Regulation*, *supra*, at 3559.

tive course of conduct alleged in the indictment was forbidden.[54]

2. This case, however, presents no abstract question about the adequacy of potential notice, derived from statute books or judicial opinions. Petitioner received explicit personal notice. As the court of appeals pointed out, "[f]ew malefactors receive such explicit warning of the consequences of their conduct" (Pet. App. A17). Warning posters appeared throughout petitioner's place of employment, stating in large, bold-face print: "You are forbidden to use any information learned from customer's copy * * *. [Y]ou are liable to criminal penalties of 5 years in jail and $10,000 fine for each offense." See pages 5-6, *supra*. Those warnings were communicated to all employees at Pandick Press through other forms of personal notification, as discussed above. *Ibid.*[55]

The district court charged the jury that it could not convict petitioner unless it believed that he acted willfully, deliberately, and intentionally, with awareness that his conduct was wrongful.[56] See pages 11-13, *supra*. The court also instructed the jury that the central issue in the case was petitioner's "state of mind." It directed the jury to consider (Tr. 692):

> Had Mr. Chiarella not seen the notices posted next to his time clock and elsewhere for many months, as he testified? Or was he not telling the truth about these notices, as the government urges, in order not to reveal to you his awareness of possible criminal penalties attached to his conduct.

The jury's guilty verdict establishes that petitioner knew that his conduct was wrongful. The jury did not choose to believe that he had never read the signs warning of criminal liability. In the words of the district court at petitioner's sentencing hearing, petitioner's claim of ignorance of criminal penalties was "perjury beyond a reasonable doubt" (Pet. App. A17 n.18). In light of the jury's finding of willful and knowing misconduct, there is no question in this case of convicting a defendant for engaging in practices that he believed to be proper.[57]

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[54] As an example of the purported unforeseeability of the court of appeals' decision, petitioner points out that a "judge's clerk" would be prohibited by that decision from buying stock on the basis of material non-public information obtained from his or her position (Br. 43 n.19). For example, a clerk aware of a forthcoming antitrust ruling could profitably purchase securities or sell them short. That this conduct is prohibited by the statute, we submit, is not a surprising consequence. Cf. *United States* v. *Peltz*, 433 F.2d 48, 52 n.4 (2d Cir. 1970).

[55] Petitioner admitted on the witness stand that he knew that his conduct was wrongful and in violation of SEC requirements. See pages 10-11, *supra*.

[56] Petitioner complains that not all of the legal analysis contained in the court of appeals' decision was included in the charge to the jury (Br. 46-47). But the jury was simply required to find the facts in the case: whether petitioner behaved as charged in the indictment, and whether his conduct was willful and knowing. Whether the conduct charged in the indictment and proven by the government at trial constitutes a violation of the statute and rule presented a legal question for the court.

[57] Petitioner argues that he believed that he was justified in behaving as he did because he observed tender offerors making open market purchases prior to announcement of

3. The decisions of this Court have consistently sustained prosecutions under criminal statutes containing general prohibitory language when the defendant's conduct is fairly encompassed by the statute and mens rea is proven by the government. This is true even when the precise coverage of the statute is subject to debate. For example, in *Nash* v. *United States*, 229 U.S. 373, 377 (1913), the Court sustained a criminal indictment charging a restraint of trade illegal under the Sherman Act's "rule of reason." [58] Similarly, in *United States* v. *National Dairy Products Corp.*, 372 U.S. 29, 31-36 (1963), the Court held that the defendants received fair notice in a prosecution for sale of goods at "unreasonably low prices." The court dismissed the argument that prosecution under this general statutory standard was unfair, noting that the defendants could not be convicted unless the government proved mens rea. See also *United States* v. *United States Gypsum Co.*, 438

their offers (Br. 48 n.21). The short answer to that assertion is that petitioner argued this point to the jury, which refused to credit it. The jury determined (by its verdict) that petitioner realized that *his* conduct was wrongful, regardless of the propriety of the behavior of other persons.

[58] See also *Omaechevarria* v. *Idaho*, 246 U.S. 343, 348 (1918) *Hygrade Provision Co.* v. *Sherman*, 266 U.S. 497, 501-503 (1925); *Gorin* v. *United States*, 312 U.S. 19, 27-28 (1941); *United States* v. *Ragen*, 314 U.S. 513, 523-524 (1942); *United States* v. *Petrillo*, 332 U.S. 1, 5-8 (1947); *Boyce Motor Lines, Inc.* v. *United States*, 342 U.S. 337, 340-342 (1952), all rejecting fair notice arguments under statutes containing prohibitions expressed in general terms, where the offense required proof of mens rea.

U.S. 422, 438-441 (1978), holding that the government may obtain a criminal conviction in a "rule of reason" antitrust case if it proves that the defendants acted with knowledge that their actions were likely to produce anticompetitive effects.[59]

Under these authorities, petitioner's "fair notice" claim is untenable. The government proved beyond a reasonable doubt that petitioner engaged in conduct that falls within the prohibition of Section 10(b). The government also proved that petitioner acted willfully and knowingly, with the realization that his behavior was wrongful. In these circumstances, even though petitioner's conduct may not have precisely duplicated that involved in prior cases, and even though the prohibitory language of Section 10(b) and Rule 10b-5 is general in scope, his conviction was properly sustained. See *United States* v. *Naftalin*, *supra*, slip op. 10. Petitioner was "given clear notice that a reasonably ascertainable standard of conduct is mandated; it [was] for him to insure that his actions [did] not fall outside the legal limits." *United States* v. *Powell*, 423 U.S. 87, 92 (1975).

[59] *Bouie* v. *City of Columbia*, 378 U.S. 347 (1964), relied on by petitioner (Br. 44-45), has no pertinence here. In that civil rights demonstration case, involving First Amendment issues, the judicial decision under review contradicted the literal text of the criminal statute that was the basis for the prosecution. The Court held that the defendants could not have foreseen such a perverse construction. As we have noted, the prohibitory statute here in question embraces all fraudulent schemes, including the scheme practiced by petitioner. There is no repugnance between the decision below and the statute.

4. The government obtained an indictment in this case to vindicate the deterrent purposes of the Act. As the evidence in this case disclosed, petitioner made over $30,000 in illegal profits. He did so through methods that approximate theft—"conversion," in the words of the court of appeals, or "embezzlement" in the words of the district court. He did so in the face of explicit warnings that his conduct would result in criminal liability. An injunction or disgorgement order is generally not a sufficient sanction to deter and punish deliberate misconduct of this kind. Such sanctions merely return the wrongdoer to the position he would have occupied if he had not engaged in the scheme to defraud. Under all the circumstances, petitioner's 30-day prison sentence, accompanied by probation, certainly was not unwarranted in light of the severity of his offense. Any lesser sanction would invite others to repeat the highly profitable fraud in which he engaged.

III. THE DISTRICT COURT CORRECTLY CHARGED THE JURY ON THE STATE OF MIND ELEMENT OF PETITIONER'S OFFENSE

Petitioner contends that the district court erred by refusing to instruct the jury that the government must prove a specific intent to defraud or deceive (Br. 49-53). He does not dispute that the district court's charge complied with Section 32(a) of the Act, 15 U.S.C. 78ff(a), which provides that any person who "willfully violates any provision of this chapter, or any rule or regulation thereunder * * *"

is guilty of a criminal offense. Rather, he argues that the court was required to charge the jury "*both* that intent to defraud was required before a * * * violation could be found and that if found, such violation was a crime if determined to be a willful violation * * *" (Br. 52-53; emphasis in original). He asserts that this two part charge on mens rea is mandated by the Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

As noted on pages 11-13 above, the district court instructed the jury that it could not convict petitioner unless it found that he engaged in the scheme to defraud alleged in the indictment and did so "wilfully and knowingly" (Tr. 682, 687, 688, 690). The court explained that the government must prove that petitioner acted "intentionally" and "deliberately," rather than through "negligence or inadvertence" (Tr. 688). The court emphasized to the jury that knowing and willful misconduct requires proof that petitioner acted with "a realization * * * that he was doing a wrongful act" and that "the knowingly wrongful act involved a significant risk of effecting the violation that occurred" (*ibid.*). The court declined to supplement these instructions on mens rea with petitioner's requested charge on specific intent to defraud (J.A. 831a):[80]

> Intent to defraud means the specific intent to deceive, cheat or trick someone. And, an intent

[80] "J.A." refers to the Joint Appendix filed in the court of appeals.

> to deceive, before being considered the specific intent which satisfies the statute, must be coupled with what may be best described as an evil ambition to injure someone and deprive him of something of value.

As we demonstrate below, the district court properly refused to give this additional charge. Neither Section 32(a) nor Section 10(b) of the Act requires the government to prove that the defendant entertained "an evil ambition to injure someone."

1. This Court's decision in *Ernst & Ernst* v. *Hochfelder*, *supra*, held that in a private damage action under Section 10(b) and Rule 10b-5 the plaintiff must plead and prove scienter and that proof of "negligence" would not suffice. The Court described scienter as a mental state "embracing intent to deceive, manipulate, or defraud." 425 U.S. at 194 n.12. Although scienter "embraces" intent to defraud, it also embraces knowing and willful misconduct;[61] moreover, as the Court pointed out, it may also embrace "reckless" conduct. *Ibid.*

An analysis of *Hochfelder* demonstrates that the Court held not that Section 10(b) requires specific intent to defraud, but rather that culpability greater than mere negligence must be shown. The plaintiffs in *Hochfelder* brought suit against the defendant auditors on the theory that they aided and abetted the fraud of the president of a brokerage house

[61] The Latin term "scienter" means "knowingly" or with "guilty knowledge." *Black's Law Dictionary* 1512 (Rev. 4th ed. 1968); *Bouvier's Law Dictionary* 3013 (3d rev. 1914).

through "negligent nonfeasance" (425 U.S. at 190). The question before the Court was "whether scienter is a necessary element of such a cause of action, or whether negligent conduct alone is sufficient" (*id.* at 197). In concluding that negligence alone would not suffice, the Court noted that the language of Section 10(b) was aimed at "knowing or intentional misconduct" (*ibid.*), a "type of conduct quite different from negligence" (*id.* at 199). The Court also pointed out that the language of the statute was inconsistent with imposition of liability "for wholly faultless conduct" (*id.* at 198) and that the legislative history demonstrates that Congress intended to prohibit conduct involving "some element of scienter" rather than "negligent conduct alone" (*id.* at 201). Congress intended Section 10(b) to apply in cases where the defendant "has not acted in good faith" (*id.* at 206). Due to the limited scope of its holding, the Court left open the question whether "reckless" conduct would suffice to maintain an action under Section 10(b) (*id.* at 194 n.12).[62]

Thus, the *Hochfelder* case lends no support to petitioner's claim that "specific intent to defraud" is required by the statute. To the contrary, the Court's repeated references to states of mind other than specific intent (including knowing and bad faith con-

[62] The Court also left open the question whether scienter must be proven in an SEC civil enforcement proceeding. See 425 U.S. 194 n.12.

duct) support the traditional view that proof of guilty knowledge is sufficient.[63]

Significantly, the pre-*Hochfelder* decisions that the Court relied on (425 U.S. at 194 n.12) recognize that liability extends to "knowing, wilful and reckless conduct." See, *e.g.*, *Clegg* v. *Conk*, 507 F.2d 1351, 1361-1362 (10th Cir. 1974), cert. denied. 422 U.S. 1007 (1975); *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc); *SEC* v. *Texas Gulf Sulphur Co.*, *supra*, 401 F.2d at 868 (Friendly, J., concurring). Similarly, the common law definition of scienter extended to conduct that was knowing, willful or reckless.[64] Finally, the appellate court de-

[63] Indeed, even if petitioner might have been entitled to an additional instruction on intent, to clarify the issue for the jury, he was not entitled to the instruction he requested. "Specific intent" to defraud has never included a particular design to cause injury. "The fact that the defendant was disinterested, that he had the best of motives, and that he thought he was doing the [victim] a kindness, will not absolve him from liability, so long as he did in fact intend to mislead." Prosser, *supra*, § 107, at 700. The district court was not obliged to give the jury an instruction that misstated the law. See 2 C. Wright, *Federal Practice and Procedure* (Criminal) § 482 at 278-279 (1969 ed.) (collecting cases); see also *United States* v. *Lam Lek Chong*, 544 F.2d 58, 68 (2d Cir. 1976).

[64] See Bucklo, *The Supreme Court Attempts to Define Scienter under Rule 10b-5: Ernst & Ernst* v. *Hochfelder*, 29 Stan. L. Rev. 213, 229 (1977) (footnotes omitted) ("Even the English case generally credited with establishing the strict intent requirement at common law, *Derry* v. *Peek* [14 A.C. 337 (1889)] purported to allow liability when the representation is 'made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false.'" Accord, W. Prosser, *Law of Torts*, § 107, at 699-701 (4th ed. 1971). 1 Harper & James, *supra*, § 7.3, at 533-535.

cisions since *Hochfelder* have uniformly held that a specific intent to defraud is not required.[65]

In sum, nothing in *Hochfelder* or the authorities that preceded or followed it supports petitioner's ar-

[65] See *Coleco Industries, Inc.* v. *Berman*, 567 F.2d 569, 574 (3d Cir. 1977), cert. denied, No. 77-1725 (Oct. 2, 1978) ("plaintiff may recover under Rule 10b-5 for misrepresentations that are recklessly made as well as those made with conscious fraudulent intent"); *First Virginia Bankshares* v. *Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977), cert. denied, 435 U.S. 952 (1978) ("[t]he defendant must know of the falsity of the information, or must act in reckless disregard of its falsity, or must intend to deceive"); *Sundstrand Corp.* v. *Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir.), cert. denied, 434 U.S. 875 (1977) ("recklessness should be viewed as the functional equivalent of intent"); *Sanders* v. *John Nuveen & Co.*, 554 F.2d 790, 792 (7th Cir. 1977) (" 'reckless behavior' can be sufficient to constitute scienter"); *Wright* v. *Heizer Corp.*, 560 F.2d 236, 251 (7th Cir. 1977) (cites with approval the recklessness standard in *Sundstrand Corp.* v. *Sun Chemical Corp.*, *supra*, and *Sanders* v. *John Nuveen & Co.*, *supra*); *Rolf* v. *Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46 (2d Cir.), cert. denied, No. 78-560 (Dec. 4, 1978) ("*Hochfelder* left intact our rule that recklessness is a form of scienter in appropriate circumstances"); *Nelson* v. *Serwold*, 576 F.2d 1332, (9th Cir.), cert. denied, No. 78-182 (Nov. 13, 1978) ("Congress intended the ambit of § 10(b) to reach a broad category of behavior, including knowing or reckless conduct"); *Edward J. Mawod & Co.* v. *SEC*, 591 F.2d 588, 596 (10th Cir. 1979) ("*Hochfelder* does not require that there be premeditated malice. It recognized that the carrying on of manipulative or deceptive device or contrivance was itself evidence that knowledge existed."); *Mansbach* v. *Prescott, Ball & Turben*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,861, at 95,526 (6th Cir. 1979) ("recklessness constitutes sufficient scienter") *McLean* v. *Alexander*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,879, at 95,601, 95,605 (3d Cir. 1979) ("reckless conduct is actionable under Section 10(b)").

gument that the government must prove a specific intent to defraud some victim. See *United States* v. *Charnay*, 537 F.2d 341, 351, 357-359 (9th Cir.), cert. denied, 429 U.S. 1000 (1976), rejecting the assertion that *Hochfelder* changes the traditional "willfulness" standard required by Section 32(a) of the Securities Exchange Act.[66] As the courts below recognized, a charge to the jury that the government must prove that the defendant acted willfully and knowingly, with a realization that his conduct is wrongful and likely to produce the violation that results, fully comports with the requirements of *Hochfelder* and the criminal penalty section of the Act.

2. In addition to its lack of support in statutory or case authority, petitioner's proposed instruction that the government must prove "an evil ambition to injure someone" has no logical application in a case of this kind. Persons trading on the basis of material non-public information could not be proceeded against by the government in either criminal or civil enforcement actions if Section 10(b) required such proof. By hypothesis, traders in petitioner's position deal through their brokers on a securities exchange. They do not know who sells them securities or who buys securities from them. In these circumstances, persons trading on non-public information would almost never entertain "an evil ambition to injure

[66] The "willfulness" standard prescribed by Congress is described in *United States* v. *Peltz*, 433 F.2d 48, 54-55 (2d Cir. 1970), cert. denied, 401 U.S. 955 (1971), and *United States* v. *Dixon*, 536 F.2d 1388, 1395-1397 (2d Cir. 1976).

someone." Their sole objective would be to make a quick profit, and not to get caught. If the rule against trading on material non-public information is to be enforced at all, it must embrace situations in which the defendant acts deliberately and intentionally in making a secret profit, with knowledge that the information that he uses is non-public and with the realization that he is acting wrongfully.

In the present case, petitioner stipulated that he did not disclose the material information that he used. He admitted that he learned the information by decoding confidential documents. He told his broker that he wanted to make a quick profit, and the evidence showed that his quick profit was substantial. He admitted on the witness stand that he knew that his conduct was wrongful. See pages 9-10, *supra*. In sum, the government proved culpable action and a culpable state of mind. Nothing more could realistically be shown in a case of this kind.

These considerations were recently addressed by the Court in *United States* v. *United States Gypsum Co.*, *supra*. In that case, the Court held that criminal prosecutions under the antitrust laws required proof of *mens rea*, but it rejected the defendants' assertion that a specific intent to inflict injury or to violate the law was also required. The Court noted that when the government proves that the defendants were "consciously behaving in a way the law prohibits," such conduct "is a fitting object of criminal punishment." 438 U.S. at 445. The Court pointed out that "[a] requirement of proof not only of * * *

knowledge of likely [anticompetitive] effects, but also of a conscious desire to bring them to fruition or to violate the law would seem, particularly in such a context, both unnecessarily cumulative and unduly burdensome." *Id.* at 446. The Court's analysis of specific intent in *United States Gypsum Co.* is equally applicable here and underscores the correctness of the decision of the court below.

IV. THE DISTRICT COURT CORRECTLY RECEIVED IN EVIDENCE AN ADMISSION MADE BY PETITIONER TO THE NEW YORK DEPARTMENT OF LABOR

Petitioner finally contends (Br. 53-69) that the district court committed reversible error by admitting into evidence a report prepared by an employee of the New York Department of Labor, which summarized petitioner's remarks during an interview concerning unemployment compensation. That summary (Gov. Ex. 12) stated the following:

> I was discharged for violating Company rule re disclosure of client information. The allegation is true. It was a matter of a printing of stock tender offers & I utilized the information for myself. This happened last year & through investigation by S.E.C., the matter came to light & I was discharged.

Petitioner argues (Br. 54) that "[b]oth federal and state interests strongly favor preserving the confidentiality of the statement." As we demonstrate below, neither state nor federal interests support exclusion of this relevant piece of evidence in a federal criminal prosecution.

1. The principal basis for petitioner's argument in favor of exclusion is his assertion (Br. 54) that the law of New York "mandates, in no uncertain terms, confidentiality of information provided in connection with a claim for unemployment insurance." However, the New York statute (N.Y. Lab. Law § 537) (McKinney 1977) prescribes no such absolute privilege. The statute provides in pertinent part (emphasis supplied):

> Information acquired from employers or employees pursuant to this article shall be for the exclusive use and information of the commissioner in the discharge of his duties hereunder and shall not be open to the public nor be used in any court in any action or proceeding pending therein *unless the commissioner is a party to such action or proceeding* * * *. Such information insofar as it is material to the making and determination of a claim for benefits shall be available to the parties affected *and, in the commissioner's discretion, may be made available to the parties affected in connection with effecting placement.*

Thus, the statute itself recognizes that countervailing public need can justify disclosure. If the Commissioner of Labor is a party plaintiff or defendant in a court proceeding, or intervenes therein, the statute authorizes disclosure. And, in the Commissioner's discretion, confidential information may be revealed to third parties in the course of placing unemployed workers.

Significantly, the New York Department of Labor interprets the statute to permit disclosure of confidential files to the Federal Bureau of Investigation. As the witness from the Department of Labor testified, the FBI is given access to "all the records in the office" (Tr. 278-279). Moreover, the report in question was released for use at trial with approval of New York's Commissioner of Labor (J.A. 67a-68a). In light of the practice of the New York authorities to disclose their reports to the agency of the federal government responsible for the investigation of federal crimes, and in view of the fact that the Commissioner of Labor himself authorized release of petitioner's report, the argument that use of the report at trial "frustrates" the policies of the State of New York is wholly untenable.

2. Fed. R. Evid. 402 succinctly states the federal policy in this area. Unless explicitly barred by the Constitution, federal statute, or federal rule, "[a]ll relevant evidence is admissible." Fed. R. Evid. 501 defines the exceptional circumstances in which relevant evidence may be excluded on grounds of privilege:

> Except as otherwise required by the Constitution of the United States or provided by Act of Congress or in the rules prescribed by the Supreme Court * * * the privilege of a witness * * * shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in light of reason and experience.

As the court of appeals recognized (Pet. App. A23), New York's statutory privilege was unknown at

common law.[67] Moreover, although petitioner argues that federal constitutional and statutory "policies" support his claim of privilege, he points to no provision of the Constitution or any federal statute or rule that prohibits use of the report.[68]

Because no federal statute, constitutional provision, or common law principle requires exclusion of this relevant evidence, the courts below correctly declined to erect a new federal privilege. As this Court noted in *United States* v. *Nixon*, 418 U.S. 683, 709 (1974): "The need to develop all relevant facts in the adversary system is both fundamental and comprehensive. The ends of criminal justice would be defeated if judgments were to be founded on a partial or speculative presentation of the facts. The very integrity of the judicial system and public confidence in the system depend on full disclosure of all the facts, within the framework of the rules of evidence." The Court added that "[w]hen the ground for asserting privilege * * * in a criminal trial is based only on generalized interest in confidentiality, it cannot prevail over the fundamental demands of due process of law in the fair administration of criminal justice." *Id.* at 713. See also *Herbert* v. *Lando*, No. 77-1105 (Apr. 18, 1979), slip op. 20-21 ("[e]videntiary privileges in litigation are not favored");

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[67] See *Coyne* v. *O'Connor*, 121 N.Y.S. 2d 100, 101 (Sup. Ct. 1953), describing the privilege as a "statutory privilege," rather than "the common-law variety of absolute privilege."

[68] We address petitioner's policy arguments on pages 92-95, *infra*.

United States v. *Nobles*, 422 U.S. 225, 230-231 (1975); *Branzburg* v. *Hayes*, 408 U.S. 665, 690 & n.29 (1972); *United States* v. *Bryan*, 339 U.S. 323, 331-332 (1950); 8 J. Wigmore, *Evidence* §§ 2192, 2193 (McNaughton rev. 1961).[69] The state civil cases relied on by petitioner (Br. 56) do not announce a rule of law that controls the receipt of evidence in this federal criminal prosecution. See *Wolfle* v. *United States*, 291 U.S. 7, 12-13 (1934); *Funk* v. *United States*, 290 U.S. 371, 381-387 (1933).

3. a. Petitioner's contention (Br. 64-65) that the New York privilege has been transmuted into a federal privilege by the Federal Unemployment Tax Act, 26 U.S.C. 3304(a)(16), (17), is insubstantial. As the court below correctly pointed out, petitioner did not raise this claim in the district court as a ground for exclusion of his statement (Pet. App. A22 n.22). For this reason, petitioner waived the claim. See Fed. R. Evid. 103(a)(1). In any event, petitioner's reliance on the statute is misplaced. The Federal Unemployment Tax Act merely specifies conditions

[69] Consistent with these authorities, the lower federal courts have shown great reluctance to adopt state privileges in federal criminal proceedings, where those privileges lack clear support in federal common law. See, *e.g.*, *In re Special April 1977 Grand Jury*, 581 F.2d 589, 592-593 (7th Cir. 1978), cert. denied, No. 78-403 (Dec. 11, 1978); *In re Grand Jury Impaneled January 21, 1975*, 541 F.2d 373, 378-383 (3d Cir. 1976); *United States* v. *Cortese*, 540 F.2d 640, 642-643 (3d Cir. 1976); *United States* v. *Craig*, 528 F.2d 773, 781-784 (7th Cir.) (Tone, J., concurring), adopted en banc, 537 F.2d 957, cert. denied, 425 U.S. 973 (1976). This Court will address a related question this Term in *United States* v. *Gillock*, No. 78-1455.

for federal approval of state unemployment compensation statutes and provides that the states must offer safeguards to prevent misuse of information obtained by state agencies. It nowhere indicates that information obtained by state agencies administering unemployment compensation statutes must be suppressed in federal criminal trials.[70]

b. Petitioner also argues (Br. 59, 65-66) that proposed Fed. R. Evid. 502 (56 F.R.D. 183, 234-235 (1973)) would have recognized a privilege in favor of persons making reports "required by law to be made" if the relevant state statute so provided. Proposed Rule 502 is irrelevant here for three reasons. First, New York's statute does not withhold information from the federal government in criminal cases, as previously noted. Second, the report in question was not "required by law to be made." Rather, it was the product of petitioner's voluntary application for benefits. Finally, and most fundamentally, the proposed rule of evidence relied on by petitioner was never adopted by Congress. During hearings on the proposed rule, witnesses expressed disapproval of the recognition of state privileges in federal criminal proceedings (see *Rules of Evidence* (*Supplement*):

[70] As the court of appeals observed (Pet. App. A22 n.22), state unemployment compensation statutes providing for disclosure of information to prosecuting authorities have been approved under the Federal Unemployment Tax Act. See Mass. Ann. Laws ch. 151A, § 46 (Michie/Law. Co-op. 1976); Wash. Rev. Code § 50.13.060, 50.13.070 (Supp. 1978). See also 43 Fed. Reg. 51473 (1978), noting the Secretary of Labor's approval of these statutes.

Hearings on the Proposed Federal Rules of Evidence Before the Subcomm. on Criminal Justice of the House Comm. on the Judiciary, 93d Cong., 1st Sess. 47, 49-50 (1973) (views of Senator McClellan)). Congress abandoned the proposed rule in favor of the current version of Rule 501, which provides that privileges in federal criminal cases are defined by the federal common law. See S. Rep. No. 93-1277, 93d Cong., 2d Sess. 6 (1974); H.R. Rep. No. 93-650, 93d Cong., 1st Sess. 8 (1973); H.R. Conf. Rep. No. 93-1597, 93d Cong., 2d Sess. 7-8 (1974). See also *In re Grand Jury Impaneled January 21, 1975*, *supra*, 541 F.2d at 378-383.

c. Petitioner further argues (Br. 66-67) that the policies of the Fifth Amendment bar use of his admission. That contention was not raised in the court below and should not be reviewed here. See *United States* v. *Lovasco*, 431 U.S. 783, 788 n.7 (1977). In any event, petitioner's argument is insubstantial.

Petitioner did not refuse to provide information to the New York Department of Labor on Fifth Amendment grounds or otherwise assert a Fifth Amendment privilege. Under these circumstances, he may not contend that use of his statement infringed the Fifth Amendment. See *Garner* v. *United States*, 424 U.S. 648, 655 (1976) ("[o]nly the witness knows whether the apparently innocent disclosure sought may incriminate him, and the burden appropriately lies with him to make a timely assertion of the privilege. If, instead, he discloses the information sought, any incriminations properly are viewed as not compelled."). See also *United States* v. *Kordel*, 397 U.S. 1, 7-13 (1970) (persons providing answers to interrogatories may not later assert "self incrimination" when those answers are used in a criminal prosecution); *California* v. *Byers*, 402 U.S. 424, 427-431 (1971) (statute requiring disclosure of information for general regulatory purposes does not result in "self incrimination").

Moreover, petitioner was not "compelled" to make any statement. Nor was he ever promised that his statement would be kept confidential—much less offered "immunity" from use of his statements in a criminal prosecution. Compare *New Jersey* v. *Portash*, No. 77-1489 (Mar. 20, 1979), slip op. 9.[71] Unlike taxpayers who are required to file tax returns (*Garner* v. *United States*, *supra*) or motorists who are required to furnish information about traffic accidents (*California* v. *Byers*, *supra*), petitioner was not subject to any legal obligation to make a statement. He therefore may not assert that he was forced to incriminate himself. *Garner* v. *United States*, *supra*, 424 U.S. at 654-656.

4. Finally, petitioner argues that his admission had "the dramatic impact of a written confession"

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[71] Although petitioner took the witness stand and testified at trial, he did not assert that he received any promise of confidentiality or immunity. The employee from the New York Department of Labor who communicated with petitioner and transcribed his statement testified that if petitioner had inquired about the use to which his statement could be put, he would have been informed that it could be turned over to the FBI (Tr. 278-279).

(Br. 68). He makes that assertion despite his recognition that the statement "did not significantly add to the government's evidence" (*ibid.*). We note that petitioner's "confession" consisted simply of a statement that he was fired for violating company rules and an admission that the charge of violating those rules was "true." The government clearly established these undisputed facts by independent proof (see pages 5-11, *supra*). Thus, although relevant and admissible, petitioner's statement was merely cumulative evidence.

Significantly, petitioner's admission said nothing whatsoever about the central issue in the case—the existence of *mens rea*. As petitioner notes (Br. 49), his "sole defense on the merits was that he denied having an intent to defraud." His prior admission was entirely consistent with his position at trial that, although he knew of his company's rules, he did not act with a state of mind sufficiently culpable to give rise to criminal liability. Since the admission had no bearing on petitioner's "sole defense," it is difficult to credit his assertion that it prejudiced him or that it forced him to take the witness stand (Br. 69).[72]

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[72] If, indeed, petitioner had been forced to take the witness stand to rebut the admission, one would expect that he would have presented contradictory evidence. To the contrary, however, he repeatedly admitted both on direct and cross examination that he used confidential client information for trading in the stock market, realizing that this constituted a violation of his company's rules and could lead to discharge (Tr. 475-521).

In sum, receiving petitioner's admission resulted only in duplication of undisputed evidence. The admission did not have any bearing on what petitioner designates as his "sole defense" on the merits. Under these circumstances, even if the district court committed error in receiving the admission, that error could not have affected the outcome of the trial. See *Kotteakos* v. *United States*, 328 U.S. 750, 757-765 (1946).

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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AUGUST 1979

APPENDIX

(Gov. Ex. 18)

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No. 1202

In the Supreme Court of the United States

OCTOBER TERM, 1978

VINCENT F. CHIARELLA, Petitioner
v.
UNITED STATES OF AMERICA, Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION FOR LEAVE TO FILE MEMORANDUM AMICUS CURIAE and MEMORANDUM AMICUS CURIAE OF THE SECURITIES INDUSTRY ASSOCIATION

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION FOR LEAVE TO FILE MEMORANDUM AMICUS CURIAE

Pursuant to Rule 42(3) of this Court's Rules, the Securities Industry Association (the "Association") respectfully moves the Court for leave to file the attached Memorandum *amicus curiae*. The petitioner, Vincent F. Chiarella, has declined to consent to the filing of such a memorandum; the respondent, United States of America, has consented.

The Association is comprised of approximately 500 brokers and dealers in securities, who transact business throughout the United States and the free world. Its members service securities investors of every size and type, and perform a complete spectrum of professional securities activities. The Association is generally recognized as a spokesman for the securities industry.

The decision below articulates a novel theory of liability under Section 10(b) of the Securities Exchange Act of 1934,* and Rule 10b-5 thereunder,** that could be in appro-

* 15 U.S.C. §78j(b).

** 17 CFR §240.10b-5 (1978).

priately applied in the future to the normal and beneficial trading activities of securities brokers and dealers. Although Rule 10b-5 liability may, under appropriate circumstances, be applied to abuses of market information, the failure of the court below to consider the potential ramifications of its broadly-defined test of liability could upset careful statutory and regulatory approaches to complex market functions.

Leave of this Court is sought to offer the Association's different perspective on the proper resolution of the important liability questions the parties have raised, so that the decision in this case can most effectively be reconciled with the legislative history, structure, and purposes of the Securities Exchange Act.

For the foregoing reasons, the Association should be permitted to file the attached Memorandum *amicus curiae*.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 1202

VINCENT F. CHIARELLA, Petitioner

v.

UNITED STATES OF AMERICA, Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM OF THE SECURITIES INDUSTRY ASSOCIATION, AMICUS CURIAE

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A34)* is reported at 588 F.2d 355. The opinion of the district court (Pet. App. B1-B3) is reported at 450 F.Supp. 95.

JURISDICTION

The judgment of the court of appeals was entered on November 29, 1978. A timely petition for rehearing, and a suggestion that such rehearing be held *en banc*, were denied on January 4, 1979. The petition for a writ of certiorari was filed on February 2, 1979, and was granted on May 14, 1979. The jurisdiction of this Court rests on 28 U.S.C. §1254(1).

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* References to the Appendix filed in this Court with the Petition for a Writ of Certiorari are cited as "Pet. App. ____"

STATUTE AND RULE INVOLVED

The decision below raises "novel" questions of first impression, articulated in a criminal proceeding, concerning the scope and application of Section 10(b) of the Securities Exchange Act of 1934 (the "Securities Exchange Act" or the "Act")* and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission (the "SEC" or the "Commission").**

QUESTION ADDRESSED

Given that, in the course of their normal securities trading activities, securities dealers regularly receive "market information," uses of which are subject to a statutory and regulatory scheme applicable to such dealers' trading activities, did Congress intend, as the court below suggested, that the "'catchall'"*** antifraud provision of Rule 10b-5 should be utilized to impose upon securities dealers an expanded prohibition against the conduct of their normal securities trading activities while in the possession of material, nonpublic, market information?****

STATEMENT

1. The petitioner, Vincent F. Chiarella, seeks the reversal of the decision of the court of appeals which affirmed his conviction, after a jury trial, for violations of Sections

* 15 U.S.C. §78j(b).

** 17 CFR §240.10b-5 (1978).

*** *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 202, *rehearing denied*, 425 U.S. 986 (1976). *Cf. International Brotherhood of Teamsters* v. *Daniel*, 439 U.S. ___, 99 S. Ct. 790, 801-802 (1979).

**** The Securities Industry Association limits the expression of its views to the issue specified in the text.

10(b) and 32(a)* of the Securities Exchange Act, and Rule 10b-5 thereunder. The petitioner was employed by a financial printer as a "markup man" (Pet. App. A3); in that capacity, he regularly received, among other things, early drafts of forms promulgated by the SEC to require the public disclosure of tender offers for the control of the stock of publicly-held companies (Pet. App. A3-A4).

In this case, the petitioner is alleged to have deciphered the identities of several prospective tender offer targets, (despite efforts to keep that information confidential) and, thereafter, to have engaged in a series of transactions in each target company's stock, buying immediately before, and selling shortly after, the announcement of the tender offer (Pet. App. A2, A4). In all, the petitioner engaged in some seventeen securities transactions, involving five separate tender offers, for a profit of more than $30,000 (Pet. App. A3-A5).

2. The petitioner was indicted on seventeen separate counts—representing each transaction—of the willful misuse of material, nonpublic information in connection with the purchase and sale of securities (*id.*). Specifically, the petitioner was indicted for his use of the nonpublic information about impending tender offers, *coupled with* his failure to disclose that information prior to his purchases of target companies' securities.

Following the indictment, the district court heard, and subsequently denied, the petitioner's motion to dismiss. Despite the Government's concession that this case involved "a novel application of §10(b)" (Pet. App. B1-B2), the district court concluded that the petitioner's "alleged misuse of information . . . falls within the intent of Congress in the enactment of §10(b) . . ." (Pet. App. B3).

3. After a trial that resulted in a jury verdict of conviction on all seventeen counts, the petitioner appealed on the

* 15 U.S.C. §78ff(a).

ground that, since he was not an insider of any of the target companies whose securities he purchased, he did not owe any fiduciary duty to target company shareholders who sold their stock before the various tender offers were publicly announced. As a result, he urged that he was free to trade on the information in question without that trading constituting a violation of Rule 10b-5 (Pet. App. A6). The petitioner also raised a number of additional grounds for the reversal of his conviction, involving issues of due process, standards of culpability and procedural error (Pet. App. A18-A23). The court of appeals rejected these contentions and affirmed the conviction by a divided vote.*

The court below broadly perceived Section 10(b) of the Securities Exchange Act as a provision designed to prohibit "conduct that destroy[s] confidence in the securities markets," and to forbid "'those manipulative and deceptive practices which have been demonstrated to fulfill no useful function'" (Pet. App. A14-A15). The court found it "irrelevant" (Pet. App. A6) that no prior adjudicated decision of any court had held someone in Mr. Chiarella's position liable —civilly or criminally—under Rule 10b-5.

Rather, the court below focused on the "strategic places in the market mechanism" occupied by financial printers (Pet. App. A7), and held that such persons must "be forbidden to reap personal gains from information received by virtue of their position" (*id.*). The court of appeals apparently rejected (Pet. App. A8 n.8) any meaningful distinction between *inside* corporate information (that is, information which emanates from *within* a corporation and relates directly to that corporation or its activities) and so-called "*market* information" (that is, information which emanates from *outside* the corporation and relates to the *market* for

* Chief Judge Kaufman wrote the majority opinion, joined by Circuit Judge Smith. Circuit Judge Meskill dissented in a separate opinion.

the corporation's stock*); instead, the court held (Pet. App. A7) that "'all investors trading on impersonal exchanges [should] have relatively equal access to material information.'"

In this context, the court below opined that its newly-established class of "*market* insiders"—persons who regularly receive nonpublic, outside, information concerning publicly-held corporations—may be liable to the same extent as *corporate* insiders (Pet. App. A7-A9). And, using the broad language that is the focus of this brief, the court below stated:

> "*Anyone*—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose. And if he cannot disclose, he must abstain from buying or selling."

Pet. App. A8 (emphasis in original, footnote omitted).**

THE INTEREST OF THE SECURITIES INDUSTRY ASSOCIATION

The Securities Industry Association (the "Association") is comprised of approximately 500 brokers and dealers in securities, who transact business throughout the United

* Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. Pa. L. Rev. 798, 799 (1973); *In re Oppenheimer & Co.*, [1975-1976 Decisions] CCH Fed. Sec. L. Rep. ¶80,551 (SEC, Apr. 2, 1976).

** Despite the breadth of this statement, the court below cautioned (Pet. App. A10) that it should "not . . . be understood as holding that no one may trade on nonpublic information without incurring a duty to disclose." The court failed, however, to articulate precisely who might be able to "trade on nonpublic information without incurring a duty to disclose," although it did hold that prospective tender offerors are *not* "market insiders" and therefore do not owe a fiduciary duty to the securities marketplace (Pet. App. A10-A11).

States and the free world. Its membership is responsible for over 90 percent of the securities brokerage business conducted in this Country, and includes members of every national securities exchange, as well as securities firms that are not members of any exchanges.

The Association's members service securities investors of every size and type, and perform a complete spectrum of professional securities activities, including retail and institutional brokerage, over-the-counter market making, underwriting and other investment banking activities, various exchange floor functions, and money management and investment advisory services. As a consequence, the Association is generally recognized as a spokesman for the securities industry.

Because the test of Rule 10b-5 liability enunciated by the court below was overly-broad, and could be inappropriately applied in the future to normal and beneficial trading activities of securities brokers and dealers, the Association respectfully submits this memorandum, *amicus curiae*.

SUMMARY OF DISCUSSION

As this Court has recently reiterated, a "key part" of the Congress' program of economic recovery after the stock market crash in 1929 was not only the "[p]revention of frauds against investors . . . , but [also] . . . the effort 'to achieve a high standard of business ethics . . . *in every facet of the securities industry.*'"* In that context, Congress sought not simply to regulate securities dealers, but to do so in a manner most calculated to assure the viability of the

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* *United States* v. *Naftalin*, 441 U.S. ——, ——, 47 U.S.L.W. 4574, 4576 (May 21, 1979) (emphasis in original), quoting *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186-187 (1963).

securities markets as an integral part of the capital-raising function so necessary to a free economy.*

Recognizing the complexity of the securities marketplace, and the need for clarity in defining the proper role of market professionals, the Congress expressly delineated the generic standards to which it believed securities dealers should adhere, bestowing direct rulemaking authority on the Securities and Exchange Commission to fill in the interstices of the statutory scheme, within appropriately circumscribed parameters. The Association's members are thus part of a securities industry that is highly regulated. Rules promulgated by the SEC span nearly 1,000 pages of Volume 17 of the Code of Federal Regulations, and the steady stream of daily interpretations, opinions, releases, and reports promulgated by the Commission consumes thousands of additional pages of fine type each year.

Moreover, in order to place most of the emphasis for the development of ethical standards where it properly belongs—on the securities industry itself—the Congress in 1934 also established a unique statutory pattern of supervised self-regulation of the securities industry,** a statutory pattern only recently reaffirmed and expanded.*** This sys-

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* *United States* v. *Naftalin*, *supra*, 441 U.S. at ——, 47 U.S.L.W. at 4576; *accord*, *Gordon* v. *New York Stock Exchange, Inc.*, 422 U.S. 659, 689 (1975). *And see* Section 11A(a)(1)(A) of the Securities Exchange Act, 15 U.S.C. §78k-1(a)(1)(A) ("The Congress finds that . . . [t]he securities markets are an important national asset which must be preserved and strengthened").

** *Silver* v. *New York Stock Exchange, Inc.*, 373 U.S. 341, 349-356 (1963); *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Ware*, 414 U.S. 117, 127-128 (1973); *Gordon* v. *New York Stock Exchange, Inc.*, *supra*, 422 U.S. at 667, 681.

*** *See* P. L. 94-29, 94th Cong., 1st Sess. (Jun. 4, 1975); H. R. Rep. No. 94-123, 94th Cong., 1st Sess. 91 (Apr. 7, 1975); H. R. Rep. No. 94-229, 94th Cong., 1st Sess. 44, 48-49 (May 19, 1975); S. Rep. No. 94-75, 94th Cong., 1st Sess. 22-23 (Apr. 14, 1975).

tem of supervised self-regulation accounts for the promulgation of extensive, additional, regulations applicable to the securities trading activities of the Association's members.*

The decision below jeopardizes this carefully constructed statutory scheme of direct, as well as self, regulation. It suggests that securities dealers, who of necessity must, and constantly do, have access to undisclosed "market" information, may *automatically* be disabled from their normal and beneficial trading activities. To that extent, by utilizing such a diffuse test of Rule 10b-5 liability,** the court of appeals has, unnecessarily and detrimentally, " 'manufacture[d] ambiguity where none exists.' "***

The development of standards of conduct applicable to market trading by such professionals should continue to be primarily the result of rulemaking by the SEC and the securities industry self-regulators, since rules of that nature, unlike *ad hoc* adjudications under generic antifraud provisions, are subject to appropriate procedural safeguards, and can be carefully tailored to take account of market complexities.

Although Rule 10b-5 properly may be applicable to the abuse of so-called "market" information, such an application

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* *See, e.g.*, Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 847-860; *accord*, Subcommittees of American Bar Association Section of Corporation, Banking, and Business Law, *Comment Letter on Material, Non-Public Information* (Oct. 15, 1973) reprinted in BNA, *Securities Regulation & Law Report*, No. 233 (Jan. 2, 1974), pp. D-1 through D-7 (hereinafter "American Bar Association Comment Letter").

** *See Securities and Exchange Commission* v. *National Securities Inc.*, 393 U.S. 453, 465 (1969).

*** *United States* v. *Naftalin*, *supra*, 441 U.S. at ——, 47 U.S.L.W. at 4577, quoting *United States* v. *Culbert*, 435 U.S. 371, 379 (1978).

of the Rule should rest (as it traditionally has) on more precisely drawn grounds than were articulated by the court below. As this Court has previously suggested, the mere status of an individual as a "market insider" is not, without more, generally sufficient to warrant the imposition of liability under Rule 10b-5.* Moreover, "not every failure to disclose material information constitutes a violation of the anti-fraud rules."**

There is little doubt, of course, that, where any person (market professional or otherwise) possesses material, nonpublic, market information and makes *affirmative* misrepresentations about that information to a purchaser or seller of securities in connection with a securities transaction, Rule 10b-5 liability could properly be invoked.*** And, at least in some circumstances, where a person in possession of material, nonpublic, market information affirmatively *induces* specific purchases or sales of securities without disclosing that information, Rule 10b-5 liability has also been deemed appropriate.****

But, in the absence of either of these circumstances, the imposition of Rule 10b-5 liability for the mere failure to

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* *See Affiliated Ute Citizens of the State of Utah* v. *United States*, 406 U.S. 128, 152, *rehearing denied*, 408 U.S. 931 (1972) ("[w]e would agree that if the [defendant] had functioned merely as a transfer agent, there would have been no duty of disclosure here"); *accord, e.g.*, Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 804: "The duty to disclose material, non-public information has not been imposed on every person possessing this type of information."

** American Bar Association Comment Letter, *supra*, at p. D-6.

*** *See, e.g.*, Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 802 & n.18.

**** *Affiliated Ute Citizens of the State of Utah* v. *United States*, *supra*, 406 U.S. at 153.

disclose material, nonpublic, market information should be limited to situations involving either

> (i) a deliberate breach of a duty to disclose such information pursuant to a clear and statutorily-articulated fiduciary relationship owed to the purchaser (or seller) of securities;* or
>
> (ii) the deliberate utilization of such information for purely personal purposes, in circumstances where the information was received solely by virtue, and in furtherance, of a confidential business relationship, where there is a clear showing "that an expectation of fair dealing . . . is justified."**

To the extent the decision of the court below implies any broader extension of Rule 10b-5 liability to cover normal trading activities of securities dealers, it is without either precedent or logic.

DISCUSSION

THE STANDARD OF RULE 10b-5 LIABILITY ARTICULATED BY THE COURT BELOW IS OVERLY-BROAD AND, AS A RESULT, COULD ADVERSELY AFFECT THE TRADING ACTIVITIES OF MARKET PROFESSIONALS.

A. The Court of Appeals Inappropriately Embraced a Broad Standard of Rule 10b-5 Liability Without Considering the Comprehensive Provisions in the Securities Exchange Act for the Regulation of the Trading Activities of Securities Dealers.

Prior to the decision below, the "disclose-or-abstain" rule it enunciates for those in possession of material, nonpublic,

* *See, e.g.*, American Bar Association Comment Letter, *supra*, at p. D-6; *and see, Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 479 (1977); *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc., supra*, 375 U.S. 180; *cf. Burks* v. *Lasker*, 441 U.S. ____, 99 S. Ct. 1831, 1835-1839 (1979).

** Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 821-822.

information had not been universally applied. Indeed, traditionally, that obligation had been limited to persons with a special relationship to the company affected by the information—so-called "corporate insiders," or their tippees, who possessed inside, corporate, information.*

But, the decision of the court below can be read as effectively eviscerating any practical distinction, under Rule 10b-5, between *inside* corporate information—the traditional subject of most Government and private actions under Rule 10b-5—and *outside* market information. Such a reading of the decision could create serious and unwarranted confusion concerning the obligations of securities dealers, not to mention their exposure to potential civil liability, for normal and beneficial trading activities.

As both the SEC and Congress have noted on several occasions, however, the effectiveness of the securities market is, in important respects, dependent not only upon the participation of public investors, but also upon securities dealers, such as "[s]pecialists, block positioners and floor

* *See, e.g., In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (SEC, 1961); *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (C.A. 2, 1968) (*en banc*), *certiorari denied, sub nom. Coates* v. *Securities and Exchange Commission*, 394 U.S. 976 (1969); *In re Investors Management Co.*, Securities Exchange Act Release No. 9267, [1970-1971 Decisions] CCH Fed. Sec. L. Rep. ¶78,163 (SEC, Jul. 29, 1971); Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 804; American Bar Association Comment Letter, *supra*, at p. D-1.

traders* [who] also contribute to the public nature of securities markets by risking their capital to absorb imbalances

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* A "specialist" is a member of a national stock exchange charged with the responsibility of maintaining a fair and orderly market in those stocks assigned to it. Among other things, a specialist may be required to effect purchases and sales of securities on its own behalf in order to minimize temporary disparities between supply and demand. Specialists also receive and hold "limit orders"—that is, orders to buy or sell a stock when the market ultimately reaches a specified price. *See* 2 Securities and Exchange Commission, *Report of the Special Study of Securities Markets*, H. R. Doc. No. 95, 88th Cong., 1st Sess. 47 (1963) (hereinafter *"Special Study"*).

A "block positioner" is a broker-dealer in securities that facilitates the purchase and sale of large quantities of various securities, often by committing its own capital to buy a portion of the total number of securities involved. *See* Securities Exchange Act Release No. 15533 (Jan. 29, 1979), 44 *Fed. Reg.* 6084, 6088-6089 (Jan. 31, 1979). Although there is no consistently-applied definition of the term, a "block" of stock generally signifies at least 10,000 shares, or a quantity of stock with a current value of at least $200,000. *Id.*, 44 *Fed. Reg.* at 6089 n.45.

A "floor trader" is a registered member of a national securities exchange that regularly effects transactions for its own account on the exchange floor. *See* 2 *Special Study, supra,* at 47.

Other securities dealers include: over-the-counter market makers, dealers responsible for maintaining a continuous marketplace for securities in the non-exchange market; odd-lot dealers, exchange members that specialize in facilitating transactions in units of less than 100 shares; *bona fide* arbitrageurs, securities dealers that regularly effect proprietary trades seeking to obtain a profit from the disparity in prices available in two markets for a security and its equivalent; and risk arbitrageurs, securities dealers that regularly effect proprietary trades in a security that is, or may be, the subject of a tender offer, or other corporate reorganization, with a view toward the eventual tender or sale of such a security. *See* Securities Exchange Act Release No. 15533, *supra,* 44 *Fed. Reg.* at 6089-6090.

in supply and demand."* Indeed, the Commission has labeled as "necessary" the functions performed by these dealers in order to "increase the depth, liquidity and orderliness of trading markets, enabling investors to implement trading decisions with relative ease and confidence."**

Because of their central position in the securities trading markets, market professionals often engage in securities transactions while possessing valuable nonpublic information relating, for example, to the (i) volume and type of order flow in a particular security; (ii) existing bids and offers on a specialist's "book";*** (iii) inventory of a block positioner, particularly blocks of stock that are to be "liquidated" or "laid off"; (iv) positions of arbitrageurs and risk arbitrageurs; and (v) institutional interest in the

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* *See, e.g.,* Adoption of Securities Exchange Act Rule 19b-2, Concerning the Utilization of Membership on National Securities Exchanges for Public Purposes, Securities Exchange Act Release No. 9950 (Jan. 16, 1973), 38 *Fed. Reg.* 3902, 3918 (Feb. 8, 1973). *Accord, e.g.,* Securities Transactions by Members of National Securities Exchanges, Securities Exchange Act Release No. 15533, *supra,* 44 *Fed. Reg.,* at 6088-6091; S. Rep. No. 94-75, *supra,* at 68, 99; H. R. Rep. No. 94-123, *supra,* at 57, 72.

** Securities Exchange Act Release No. 9950, *supra,* 38 *Fed. Reg.* at 3918; *accord,* 8 Securities and Exchange Commission, *Institutional Investor Study Report,* H. R. Doc. No. 92-64, 92d Cong., 1st Sess. xxii (1971) (hereinafter *"Institutional Investor Study Report"*).

*** A specialist's "book" is a book in which he enters, as a broker, limited price orders he has received from others to purchase or sell a specific security, at a specific price that is either higher or lower than the existing market in that security, for execution at a later time when the market moves to the price designated in such orders. The information in a specialist's book has an "importance beyond that of a mere repository of unexecuted agency orders. It serves as the indicator of public interest in a particular security." 2 *Special Study, supra,* at 76.

purchase or sale of blocks of stock.* Such information may, under many circumstances, be nonpublic, material, "market" information. In light of the decision of the court below, however, there is now some possibility that trades effected by securities dealers while in the possession of such information might be deemed to violate Rule 10b-5.

But, as the SEC only recently reiterated, the Securities Exchange Act and its legislative history contemplate the frequent access of market professionals to this valuable information:

> "Traditionally, market professionals have been permitted to enjoy these market information and competitive advantages because they have obligations to the markets for the securities that they trade and have made significant contributions to the continuity, liquidity and depth of the markets for those securities." **

To that end, the Securities Exchange Act vests in the Commission and the various securities industry self-regulators direct regulatory authority to reconcile the possession by

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* *See, e.g.*, American Bar Association Comment Letter, *supra*, at p. D-6.

** Securities and Exchange Commission, *Report of the Special Study of the Options Markets*, H. R. Comm. Print No. 96-IFC3, 96th Cong., 1st Sess. 1-4 (1978) (hereinafter "*Options Study*"); *accord*, 2 *Special Study*, *supra*, at 76-83, 90, 127-128, 135, 203-242; *In re Albert Fried & Co. and Albert Fried, Jr.*, Securities Exchange Act Release No. 15293 (Nov. 3, 1978), 16 *SEC Docket* 100, 104 (SEC, Nov. 21, 1978) (The "*quid pro quo*" for conferring advantages on specialists, and other securities dealers "has been the imposition of regulation to assure that in trading for his own account he uses those privileges for the benefit of the market generally . . ."); American Bar Association Comment Letter, *supra*, at p. D-6 ("The policy in this area has been to regulate the performance of these professionals' functions rather than to eliminate their informational advantage deriving from their very function in the marketplace and thereby to deny to the public their contribution to the functioning of the market mechanism.").

securities dealers of valuable nonpublic trading information with the express goal of the Act "to insure the maintenance of fair and honest [securities] markets. . . ."*

Thus, for example, in Section 11(a) of the Act, as originally adopted,** the SEC was empowered to regulate "trading by [stock exchange] members for their own account, whether on or off the floor of the exchanges. . . ."*** Similarly, Section 11(b) of the Act, as originally enacted,**** authorized the various stock exchanges to adopt rules permitting "the registration of members as odd-lot dealers or specialists, or both,***** and authorizing these members to trade "for their own account as may be reasonably necessary to permit them to maintain a fair and

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* Section 2 of the Securities Exchange Act as originally passed, P. L. No. 291, 73d Cong., 2d Sess. §2 (Jun. 6, 1934).

** P. L. No. 291, *supra*, §11(a); *and see*, S. Rep. No. 1455, 73d Cong., 2d Sess. 29 (Jun. 6, 1934).

*** S. Rep. No. 1455, *supra*, at 29.

In 1975, Section 11(a) of the Act was significantly amended (P. L. 94-29, *supra*, §6) in light of the Congress' recognition of the "informational and market proximity advantages" of securities dealers who are privy to nonpublic, "market" information. H. R. Rep. No. 94-123, *supra*, at 54-55. In expanding the potential coverage of a ban on exchange members trading for their own accounts, however, the Congress exempted transactions by securities dealers, which were "deemed either to be beneficial to the markets or not to pose so great a danger to the fair and orderly functioning of the markets. . . ." S. Rep. No. 94-75, *supra*, at 68. Those categories include transactions by specialists, market makers, block positioners, registered odd-lot dealers, *bona fide* arbitrageurs, and risk arbitrageurs. *See* Sections 11(a)(1)(A)-(D), 15 U.S.C §§78k(a)(1)(A)-(D).

**** P.L. No. 291, *supra*, §11(b).

***** S. Rep. No. 1455, *supra*, at 29-30.

orderly market."* Significantly, although the statute contemplated that specialists could and would trade for their own accounts, under Section 11(b) specialists expressly were, and today still are, generally "forbidden to reveal information in respect to orders placed with them. . . ." **

To similar effect are the regulations adopted by the various securities industry self-regulators, pursuant to Sections 6(b)(5) and 15A(b)(8) of the Act,*** to govern the conduct, trading activities and related disclosure obligations of their constituent-member securities dealers.**** While

* *Id.*, at 30. Section 11(b) was amended in 1975 (P.L. No. 94-29, *supra*, §6) to delete the restriction in the original statute that permitted members' trading for their own accounts only to the extent necessary for the maintenance of a fair and orderly market. The change was explained as appropriate "to provide . . . greater flexibility in prescribing a specialist's obligations in a national market system." *See* S. Rep. No. 94-75, *supra*, at 100.

** S. Rep. No. 1455, *supra*, at 30. As can readily be observed, however, the "disclose-or-abstain" test of Rule 10b-5 liability proffered by the court below, if applied literally to securities dealers, would thus conflict with a specialist's statutory obligations under Section 11(b) of the Act.

*** 15 U.S.C. §§78f(b)(5) and 78*o*-3(b)(8). These sections require the stock exchanges and the National Association of Securities Dealers, Inc., respectively, to adopt rules designed, among other things, "to promote just and equitable principles of trade."

**** For example, the rules of the various exchanges establish trading requirements for specialists, who, as we have seen, are given informational advantages so that they may "assist in the maintenance, so far as practicable, of a fair and orderly market." Securities Exchange Act Rule 11b-1(a)(2)(ii), 17 CFR §240.11b-1(a)(2)(ii)(1978); *accord*, New York Stock Exchange ("NYSE") Rule 104.10, 2 CCH *NYSE Guide* ¶2104.10; American Stock Exchange ("ASE") Rule 170(b), 2 CCH *ASE Guide* ¶9310. *And see, e.g.*, NYSE Rules 104.10(5), 104.10(6), 104.11, 2 CCH *NYSE Guide* ¶¶2104.10, 2104.11 (specialist's interest in pools and options); NYSE Rule 113, 2 CCH *NYSE Guide* ¶2113 (prohibitions relating to pub-

(footnote continued on next page)

many of these rules are rather straightforward, others required the application of highly-refined expertise to assure that, in adopting regulations to govern complex market functions, the resulting rules were consistent with, and continued to foster, the efficient operation of the securities markets. Particularly where questions of market information have been involved, the development of appropriate regulations has required detailed consideration over an extended period of time.*

Numerous other provisions of the Securities Exchange Act, both as originally adopted, and as recently amended in 1975, establish a system for the comprehensive regulation

(footnote continued from preceding page)

lic customers); NYSE Rule 115, 2 CCH *NYSE Guide* ¶2115 (prohibition against the disclosure of specialists' orders). The exchanges also have detailed rules relating to odd-lot dealers, registered floor traders and block positioners. *See, e.g.*, NYSE Rule 90, 2 CCH *NYSE Guide*, ¶2090 (prohibiting certain members' transactions); NYSE Rule 108, 2 CCH *NYSE Guide* ¶2108 (limiting certain members' bids and offers); NYSE Rule 112, 2 CCH *NYSE Guide* ¶¶2112 and 2112(A) (restrictions on floor traders and reports by off-floor traders); NYSE Rule 97, 2 CCH *NYSE Guide* ¶2097 (limitation on members' trading because of block positioning); and NYSE Rule 127, 2 CCH *NYSE Guide* ¶2127 (block positioning rules).

* For example, one such practice, known as "front running," involves trading by an exchange member in a security (or an option for that security) while in the possession of nonpublic information concerning an impending block transaction in the same security. It took several years after the problem was identified for the securities industry self-regulatory organizations to develop a proscription against "front running" that would not impede legitimate trading activities. Securities Exchange Act Release No. 15262 (Oct. 20, 1978), 43 *Fed. Reg.* 52318 (Nov. 9, 1978). *See also Options Study, supra*, at 183-189.

of market professionals as well as the securities markets.* Under these circumstances, the SEC's traditional reliance upon its own rulemaking, and rulemaking by the various securities industry self-regulatory organizations, to regulate the performance of securities dealers, rather than to eliminate their informational advantages,** has " 'assure[d]

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* Thus, for example, Section 15(b)(7) of the Act, 15 U.S.C. §78*o*(b)(7), directs the SEC to establish standards for the qualification of all market professionals; and Section 11A, recently added to the Act, 15 U.S.C. §78k-1, directs the SEC to establish a national market system for trading securities, with particular emphasis on the roles of securities dealers in such a system.

And see, e.g., Securities Exchange Act Sections 6(a) and (b), 15 U.S.C. §§78f(a) and (b) (registration of national securities exchanges); 11A(b), 15 U.S.C. §78k-1(b) (registration and regulation of securities information processors); 11A(c), 15 U.S.C. §78k-1(c) (regulation of the distribution or publication of any information concerning quotations for or transactions in securities); 12(a)-(d), 15 U.S.C. §78*l*(a)-(d) (listing of securities for exchange trading); 12(f), 15 U.S.C. §78*l*(f) (unlisted trading privileges for exchange traded securities); 13(f)-(h), 15 U.S.C. §78m(f)-(h) (institutional trading and portfolio holding disclosures); 13(d), 13(e), 14(d), 14(e), and 14(f), 15 U.S.C. §§78m(d), 78m(e), 78n(d), 78n(e), and 78n(f) (regulation of tender offers and other acquisition programs); 17(a)-(b), 15 U.S.C. §78q(a)-(b) (reporting, disclosure and examination requirements for exchanges, exchange members, brokers, and dealers); 17(d), 15 U.S.C. §78q(d) (coordination of responsibilities of self-regulatory organizations); 17A(b), 15 U.S.C. §78q-1(b) (registration and regulation of clearing agencies); 17A(c), 15 U.S.C. §78q-1(c) (registration and regulation of transfer agents); and 19(a), 15 U.S.C. §78s(a) (registration process for exchanges).

** *See, e.g.*, American Bar Association Comment Letter, *supra*, at p. D-6; Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 846.

fairness and mature consideration of [these] rules of general application.' "*

Unfortunately, the decision below unnecessarily threatens to undermine this careful approach to the activities of securities dealers, but without the advantage of the same exposure to "mature" professional judgments that were made available to the Commission through the notice-and-comment procedures mandated by the Administrative Procedure Act.** In sum, the courts should exercise caution in charting new regulatory waters with Rule 10b-5. Effectively employed, that Rule certainly has an important role to play in preserving the integrity of the trading markets. But, its unduly broad application to the normal trading activities of securities dealers, as suggested by the court below, is inconsistent with the reasoned approach to the regulation of the securities markets Congress contemplated when it enacted the Securities Exchange Act over forty-five years ago.

B. Section 10(b) and Rule 10b-5 Should Not Be Utilized as the Primary Regulator of the Extent to Which Securities Dealers May Trade While in Possession of Outside, Market, Information.

The troublesome potential result of the decision below is not that it would permit securities dealers to be sued under

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* *Chrysler Corp.* v. *Brown*, 441 U.S. ____, 99 S. Ct. 1705, 1718 (1979), quoting *National Labor Relations Board* v. *Wyman-Gordon Co.*, 394 U.S. 759, 764 (1969).

** 5 U.S.C. §553. Pursuant to Section 19(b) of the Securities Exchange Act, as amended in 1975, 15 U.S.C. §78s(b), substantive rule proposals of the securities industry self-regulatory organizations are required to be subjected to notice-and-comment procedures comparable to those applicable to the Government.

Rule 10b-5,* but rather that it "would . . . bring within . . . Rule [10b-5] a wide variety of [market professional] conduct traditionally left to . . ." direct regulation by the SEC and the various securities industry self-regulators. *Cf. Santa Fe Indus., Inc.* v. *Green, supra,* 430 U.S. at 478. Thus, "[i]n addition to posing a 'danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5,' . . . this extension of [Rule 10b-5 coverage and liability] would overlap and quite possibly interfere with . . ." the express regulatory scheme devised by Congress to regulate the conduct of market professionals. *Id.,* 430 U.S. at 478-479 (citation omitted).** Neither the legislative history of Section 10(b), nor the policies underlying the adoption and administration of Rule 10b-5, justify such a result here.

At the outset, it should be recognized that, putting Section 10(b) and Rule 10b-5 to one side, Congress subjected fraud by securities dealers to both SEC rulemaking and enforcement litigation pursuant to several specific and well-focused statutory antifraud provisions. In that regard, Section 9(a) of the Securities Exchange Act, 15 U.S.C. §78i(a), delineates the classes of exchange market fraud or manipulation

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* Securities brokers and dealers that breach their professional responsibilities have long been subject to discipline for such breaches pursuant to a variety of provisions under the Securities Exchange Act, including Rule 10b-5. *See, e.g., Hanly* v. *Securities and Exchange Commission,* 415 F.2d 589 (C.A. 2, 1969); *Hughes* v. *Securities and Exchange Commission,* 174 F.2d 969 (C.A. D.C., 1949); *Charles Hughes & Co.* v. *Securities and Exchange Commission,* 139 F.2d 434 (C.A. 2), *certiorari denied,* 321 U.S. 786 (1944).

** *See also Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 210; *Touche Ross & Co.* v. *Redington,* 442 U.S. ——, 47 U.S.L.W. 4732 (Jun. 18, 1979).

Congress intended to proscribe;* even with respect to certain types of potentially-manipulative conduct on such exchanges, however, Congress required that the Commission first define and specify the conduct to be proscribed before market professionals could be subjected to private or Government litigation challenges.**

And, to the extent that Congress desired to preclude market professionals from engaging in an even broader range of "manipulative, deceptive, or other fraudulent device[s] or contrivance[s]" than had been specified in the various other sections of the Act discussed above, the SEC was vested with additional authority in Sections 15(c)(1) and 15(c)(2) of the Act.*** Significantly, however, both of these

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* Section 9(a) proscribes, for example, fictitious purchase or sale transactions (so-called "wash" sales or "matched" orders); manipulations designed artificially to raise or to lower the price of a security; false and misleading statements intended to induce purchases or sales; and the use of so-called "tipster" sheets. *See* S. Rep. No. 792, *supra,* at 17. *And see, Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 207.

** *See, e.g.,* Section 9(a)(6) of the Act, 15 U.S.C. §78i(a)(6), which prohibits various price pegging or stabilizing transactions, but only if such conduct is *expressly* in contravention of specific SEC rules. Senate Committee on Banking and Currency, *Hearings on Stock Exchange Practices,* 73d Cong., 1st Sess. 7736-7737 (1934) (remarks of Mr. Pecora). Pursuant to its authority under Section 9(a)(6), the Commission has adopted a number of complex and detailed rules to govern this type of conduct. *See* Securities Exchange Act Rules 10b-6, 10b-7, and 10b-8, 17 CFR §§240.10b-6, 10b-7, and 10b-8 (1978), adopted in Securities Exchange Act Release No. 5194 (Jul. 5, 1955), 20 *Fed. Reg.* 5076 (Jul. 15, 1955). Since these rules apply to both exchange and over-the-counter securities transactions, *both* Sections 9(a)(6) and 10(b) were relied upon as authority for their adoption. *Id. See Piper* v. *Chris-Craft Indus., Inc.,* 430 U.S. 1, 45-46 (1977).

*** 15 U.S.C. §§78*o*(c)(1) and 78*o*(c)(2). *See also* Sections 15(c)(3), 15(c)(5), and 15(c)(6) of the Act, 15 U.S.C. §§78*o*(c)(3), 78*o*(c)(5), and 78*o*(c)(6).

general market professional antifraud provisions *require* the SEC, "by rules and regulations, [to] define such devices or contrivances as are manipulative, deceptive or otherwise fraudulent," before any liability may be imposed.•

Section 10(b) and Rule 10b-5 stand in sharp contrast to these market professional antifraud provisions. Neither specifically mentions market professionals, and noticeably lacking in both are the safeguards inherent in each of the other antifraud provisions relating to market professionals —either the express statutory specification of the conduct intended to be prohibited, or a directive to the SEC to define precisely the conduct sought to be proscribed.

Although "the intended scope of §10(b) . . . [is *not*] revealed explicitly in the legislative history of the 1934 Act, which deals primarily with other aspects of the legislation,"•• such legislative history as there is reflects Congress' perception that Section 10(b) was viewed as being of essentially *supplemental* importance in accomplishing the aims of the Act.••• Indeed, Thomas G. Corcoran, a spokesman for the drafters of the Securities Exchange Act,•••• confirmed this view when he "described [Section 10(b)]

• The Commission has adopted 16 specific rules to implement its authority under Sections 15(c)(1) and 15(c)(2). *See* Securities Exchange Act Rules 15c1-1, 15c1-2, 15c1-3, 15c1-4, 15c1-5, 15c1-6, 15c1-7, 15c1-8, 15c1-9, 15c2-1, 15c2-3, 15c2-4, 15c2-5, 15c2-7, 15c2-8, and 15c2-11, 17 CFR §§240.15c1-1, 240.15c1-2, 240.15c1-3, 240.15c1-4, 240.15c1-5, 240.15c1-6, 240.15c1-7, 240.15c1-8, 240.15c1-9, 240.15c2-1, 240.15c2-3, 240.15c2-4, 240.15c2-5, 240.15c2-7, 240.15c2-8, and 240.15c2-11 (1978).

•• *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 202.

••• *See, e.g.,* S. Rep. No. 792, 73d Cong., 2d Sess. 6 (Apr. 17, 1934); H. R. Rep. No. 1383, 73d Cong., 2d Sess. 10-11 (Apr. 27, 1934); House of Representatives Committee on Interstate and Foreign Commerce, *Hearings on H. R. 7852 and H. R. 8720,* 73d Cong., 2d Sess. 115 (1934) (remarks of Thomas G. Corcoran).

•••• *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 202.

rightly as a 'catchall' clause to enable the Commission 'to deal with new manipulative [or cunning] devices.' "•

Whatever the precise scope and intent of Section 10(b), "[i]t is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was . . ." to elevate Section 10(b) into the *primary* vehicle by which the conduct of securities dealers should be regulated. *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 203. And, particularly in the context of this case, the administrative history of Rule 10b-5 confirms this analysis of Section 10(b).••

For one thing, Rule 10b-5 was adopted specifically for the purpose of addressing a misuse of *inside* corporate information.••• In promulgating the Rule, the SEC thus evidenced no intent to address the inherently more complicated issues raised by the use of market information. And, both the release adopting Rule 10b-5, and the Commission's Annual Report describing it, make clear the Commission's awareness that *separate* antifraud rules already governed fraud by market professionals. As the Commission noted: "The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole. . . ."••••

• *Id.,* 425 U.S. at 203.

•• "It suffices to say . . . that the language of the statute and not the rules must control." *Touche Ross & Co.* v. *Redington, supra,* 442 U.S. at ____ n. 18, 47 U.S.L.W. at 4737 n. 18; *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 214; *Santa Fe Indus., Inc.* v. *Green, supra,* 430 U.S. at 472.

••• [T]he president of a corporation was telling the other shareholders that the corporation was doing poorly and purchasing their shares at . . . depressed prices, when in fact the business was doing exceptionally well." *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 212 n. 32.

•••• *See* Securities Exchange Act Release No. 3230 (May 21, 1942) 13 *Fed. Reg.* 8183 (Dec. 22, 1948); Securities and Exchange Commission, *Eighth Annual Report* 10 (1942).

Moreover, the Commission's administration of Section 10(b) and Rule 10b-5 reflects its traditional understanding of the propriety of limiting the role of Rule 10b-5 in cases involving the access of securities dealers to market information.* And, even more recently, in a variety of circumstances involving the conduct of securities dealers and their potential abuses of market information, the Commission has consistently relied on, or recommended the use of, its direct regulatory powers, rather than Section 10(b) and Rule 10b-5.**

* As we have seen, to the extent trading restrictions have been imposed on market professionals, such as specialists and floor traders, these restrictions "have not historically been grounded in the antifraud provisions of the securities laws, but appear to have been developed primarily under the SEC's broad [rulemaking] powers under section 11 of the Exchange Act . . . or by the exchanges under the broad authority to regulate the conduct of their members, including the power to establish 'just and equitable principles of trade.'" Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 846; *accord*, 4 Subcomm. on Securities of the Senate Committee on Banking, Housing and Urban Affairs, *Hearings on the Senate Industry Study*, 92d Cong., 2d Sess. 67-68 (1972); American Bar Association Comment Letter, *supra*, at p. D-6. *Cf.* Note, *The Downstairs Insider: The Specialist and Rule 10b-5*, 42 N. Y. U. L. Rev. 695 (1973).

** Thus, for example, the Commission recently reported to the Congress on a year-long study of the conduct of market professionals who trade in exchange-listed options contracts. *See Options Study, supra.* Although the Commission there criticized certain alleged abuses of market information, *id.*, at 37-38, 139-153, 178-190, 948-951, and 956-962, the Commission recommended the adoption of specific rules to correct the situation (*id.*, at 188), but did not recommend reliance on either Section 10(b) or Rule 10b-5 for such a purpose. *Accord, e.g.*, 8 *Institutional Investor Study Report, supra*, xxxi-xxxii (use of information about an impending tender offer should *not* be the subject of Rule 10b-5); Securities Exchange Act Release No. 6022 (Feb. 5, 1979), 44 *Fed. Reg.* 9956 (Feb. 15, 1979) (proposal to adopt a specific rule—Rule 14e-2—to circumscribe the trading activities of would-be tender offerors and their allies once a decision to make a tender offer has been formulated).

The reasons militating against the utilization of Rule 10b-5 in such a fashion were best articulated by the SEC itself, in transmitting its *Institutional Investor Study Report* to Congress, in which the agency recommended *against* the use of Rule 10b-5 to deal with a phenomenon known as *warehousing*—a process by which a would-be tender offeror alerts "friendly" institutional investors of an impending tender offer in order to encourage the transfer of the target company's stock into the hands of investors who are likely to be receptive to the proposed tender offer when it is actually made.

In its report, the Commission expressly noted that *"different underlying principles"* from those involved in the misuse of inside information should and do govern the use of market information.* As the Commission stated, such a difference does

> "not necessarily mean that such passing on of information concerning takeovers should be permitted, but it may well mean that if such activities are to be prohibited, *this should be done by a rule specifically directed to that situation rather than by an expanded interpretation of Rule 10b-5* resting on a somewhat different theory than that underlying that rule as to the obligation and duties of those who receive material undisclosed [corporate] information."**

* 8 *Institutional Investor Study Report, supra*, at xxxii (emphasis supplied).

** *Id.* (emphasis supplied).

The difficulties inherent in attempting to articulate appropriate guidance on the extent to which the use of nonpublic market information should be subject to Rule 10b-5 has apparently been evident to the SEC even after its *Institutional Investor Study Report*. In 1973, the Commission noted both the need for and the lack of any concrete regulations in this area by requesting comments, among other things, on whether "securities [market] professionals" must disclose market information prior to trading while in possession of that information. *See* Securities Exchange Act Release No. 10316

(footnote continued on next page)

C. The Court of Appeals' Suggestion that its "Abstain-or-Disclose" Standard of Rule 10b-5 Liability Should Be Applied Automatically to All "Market Insiders" Is Overly-Broad.

The foregoing discussion is not intended to suggest that Section 10(b) and Rule 10b-5 are wholly inapplicable to market professionals who effect securities transactions while in posession of material, nonpublic, market information. One decision of this Court, as well as those of other courts, indicate that Rule 10b-5 may have a role to play in this context;* those cases, however, are rooted on significantly firmer and more precise ground than is the opinion of the court below.

For purposes of analyzing the decision below, it is not necessary to focus on the application of Rule 10b-5 to affirmative misstatements or half-truths about outside information. The court below was not confronted with such a situation, and Section 10(b) is, by its terms, applicable to all situations involving deception in connection with a securities transaction. Whether the defendant is a corporate insider or outsider, a market professional or not, and whether the information in issue emanates from within or without the corporation, false statements or half-truths made to induce

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(footnote continued from preceding page)

(Aug. 1, 1973), 2 *SEC Docket* 229 (Aug. 14, 1973). Although such guidance was promised, as the court below has noted on another occasion "[t]he SEC itself has [now] despaired of providing written guidelines. . . ." *Securities and Exchange Commission* v. *Bausch & Lomb, Inc.*, 565 F.2d 8, 10 (C.A. 2, 1977) (Kaufman, C. J.).

* *See, e.g., Affiliated Ute Citizens of the State of Utah* v. *United States, supra,* 406 U.S. at 152-153. Although this Court's decision in *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc., supra,* involved a species of outside, or market information, that action did not involve any allegation of a violation of Rule 10b-5. *See Santa Fe Indus., Inc.* v. *Green, supra,* 430 U.S. at 471 n. 11.

(or in connection with) a securities transaction are doubtlessly actionable under Rule 10b-5.*

Here, a threshold difficulty is that this case involves neither affirmative misrepresentations nor half-truths but, rather, focuses upon the petitioner's failure to speak at all. Of course, even as to silence, the courts have long recognized that the failure to speak, *when there exists a duty to do so,* may be actionable under Rule 10b-5.** But, those cases have principally involved the conduct of traditional corporate insiders (or those who derive inside information from them, a class of persons as to whom the imputation of a duty to

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* *See, e.g., United States* v. *Charnay,* 537 F.2d 341 (C.A. 9), *certiorari denied,* 429 U.S. 1000 (1976); *Securities and Exchange Commission* v. *Dolnick,* 501 F.2d 1279 (C.A. 7, 1974); *Myzel* v. *Fields,* 386 F.2d 718 (C.A. 8), *certiorari denied,* 390 U.S. 951 (1968); *Hooper* v. *Mountain States Securities Corp.,* 282 F.2d 195 (C.A. 5), *certiorari denied,* 365 U.S. 814 (1960); *In re Delafield & Delafield,* Securities Exchange Act Release No. 8480, [1967-1969 Decisions] CCH Fed. Sec. L. Rep. ¶77,648 (SEC, 1968); *In re Ward La France Truck Corp.,* 13 S.E.C. 373 (SEC, 1943); Fleischer, Mundheim & Murphy, *supra,* 121 U. Pa. L. Rev. at 802. *Cf.* Section 9(a)(4) of the Act, 15 U.S.C. §78i(a)(4).

** *See, e.g., Affiliated Ute Citizens of the State of Utah* v. *United States, supra,* 406 U.S. at 151-153; *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 495 F.2d 228 (C.A. 2, 1974); *Radiation Dynamics, Inc.* v. *Goldmutz,* 464 F.2d 876 (C.A. 2, 1972); *Chasins* v. *Smith, Barney & Co.,* 438 F.2d 1167 (C.A. 2, 1970); *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co., supra,* 401 F.2d at 848-849; *Heit* v. *Weitzen,* 402 F.2d 909 (C.A. 2), *certiorari denied,* 395 U.S. 903 (1968); *Opper* v. *Hancock Securities Corp.,* 250 F. Supp. 668 (S.D. N.Y., 1966); *In re Faberge, Inc.,* Securities Exchange Act Release No. 10174, [1973 Decisions] CCH Fed. Sec. L. Rep. ¶79,378 (SEC, 1973); *In re Investors Management Co., supra,* CCH Fed. Sec. L. Rep. ¶78,163; American Bar Association Comment Letter, *supra,* at pp. D-6-D-7. *Cf. Zweig* v. *The Hearst Corp.,* [Current Decisions] CCH Fed. Sec. L. Rep. ¶96,851 (C.A. 9, 1979).

speak, and hence the applicability of Rule 10b-5, is surely appropriate.*

The court below sought to impose a similar duty on the petitioner, apparently on the theory that Section 10(b) and Rule 10b-5 were intended to assure that all participants in the securities marketplace have "equal access" to material information of any kind (Pet. App. A7). And yet, neither the language of Section 10(b) nor its meager legislative history suggests that *absolute* equality of access was a purpose of the legislation generally, or of Section 10(b) in particular. Indeed, the abstract application of such a principle to a wide variety of situations involving securities dealers that the court below never considered, but may have encompassed by its broad language, is not a result required by anything within the statute.

There is little doubt that Congress intended to insure "equal access" to basic operating facts about companies whose securities are publicly held and traded. That desire impelled the adoption of Sections 13(a) and 15(d) of the Securities Exchange Act, 15 U.S.C. §§78m(a) and 78*o*(d), which require such companies to file public reports with the SEC setting forth, on a periodic basis, the results of their

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* As we have seen, Rule 10b-5 was adopted specifically to enable the SEC to preclude corporate insiders from abusing inside information (*see* p. 23, *supra*). Moreover, the legislative history of the Securities Exchange Act unequivocally reflects Congress' desires to preclude corporate insiders from profiting at the expense of minority shareholders by using inside information as a basis for buying or selling securities. S. Rep. No. 792, *supra*, at 9-10; H. R. Rep, No. 1383, *supra*, at 13-14. *And see*, Sections 16(a) and 16(b) of the Securities Exchange Act, 15 U.S.C. §§78p(a) and 78p(b). It is, therefore, entirely consistent with the "'catchall'" role of Section 10(b) to impose a duty on corporate insiders to abstain from trading altogether, if they cannot disclose material, nonpublic, *inside* information before effecting transactions in the securities of their corporations.

operations.* And, as noted, Congress also sought to prevent certain, specified, persons—mainly corporate insiders—from taking advantage of their superior access to material corporate information.** But, neither those provisions nor any other provisions of the Act support the broader application of the principle of equal access to *all* forms of market information, as the court below suggested.

The application of the federal securities laws antifraud proscriptions to the nondisclosure of market information, therefore, must rest on a different basis from that suggested by the court below. Traditionally, nondisclosure has been deemed to constitute fraud only where some independent duty to speak exists.*** In fact, that has been the standard generally applied in the few "market information" cases brought under the federal securities laws antifraud provisions.**** In certain circumstances, Congress did identify the kind of relationship that properly may give rise to a duty to speak, such as the situation where an investment ad-

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* S. Rep. No. 792, *supra*, at 10-11; H. R. Rep. No. 1383, *supra*, at 11-13.

** *See, e.g.*, S. Rep. No. 792, *supra*, at 9-10; H. R. Rep. No. 1383, *supra*, at 13-14; Sections 16(a) and 16(b) of the Act.

*** Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 804-805. *See also* American Bar Association Comment Letter, *supra*, at pp. D-1-D-2.

**** In *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 197, for example, the Court concluded that an injunction may be issued "to require an [investment] adviser to make full and frank disclosure of his practice of trading on the effect of his [subsequent] recommendations." The decision focused on the reliance that is inherent in fiduciary relationships between an adviser and his client. "An investor seeking the advice of a registered investment adviser must . . . be permitted to evaluate . . . overlapping motivations, through appropriate disclosure, in deciding whether an adviser is servicing 'two masters' or only one, 'especially . . . if one of the masters happens to be economic

(footnote continued on next page)

viser overreaches its clients.* Where no such *statutory* relationship exists, however, this Court has suggested that Rule 10b-5 may be an inappropriate device by which to imply new federal fiduciary duties. *Santa Fe Indus., Inc.* v. *Green, supra,* 430 U.S. at 479-480 and n. 11.** At least with respect to securities dealers engaged in their normal trading activities, as a general proposition the existence and extent of their fiduciary relationships more appropriately should be governed by express regulations; in the absence of such express regulations, and except as discussed immediately below, the creation of fiduciary relationships by implication under Rule 10b-5 should be reserved for exceptional circumstances.

Alternatively, liability under Rule 10b-5 may be predicated upon the deliberate, and purely personal, utilization of market information, where the information was received solely by virtue of a confidential business relationship, and where there is a clear showing "that an expectation of fair dealing . . . is justified."*** This has been the basis for the imposition of liability in those cases involving a misuse of market information where no federal fiduciary relationship

(footnote continued from previous page)
self-interest.' " *Id.*, at 196 (citation deleted). *See also, e.g., Courtland* v. *Walston & Co., Inc.*, 340 F. Supp. 1076 (S.D. N.Y., 1972); *Securities and Exchange Commission* v. *Alex N. Campbell*, Litigation Release No. 6567 (Oct. 30, 1974), 5 *SEC Docket* 383 (Nov. 12, 1974) (E.D. Pa.) (consent decree); *In re Kidder, Peabody & Co., Inc.*, 43 S.E.C. 911 (SEC, 1968). *Cf. Strong* v. *Repide*, 213 U.S. 419 (1909); *Zweig* v. *The Hearst Corp., supra,* CCH Fed. Sec. L. Rep. ¶96,851.

* *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc., supra. And see,* Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. §80b-6.

** *Cf. Burks* v. *Lasker, supra,* 441 U.S. at ____, 99 S. Ct. at 1838-1840; *Touche Ross & Co.* v. *Redington, supra,* 442 U.S. at ____, 47 U.S.L.W. at 4734-4735.

*** Fleischer, Mundheim & Murphy, *supra,* 121 U. Pa. L. Rev. at 822.

exists.* Since market professionals appropriately may effect certain securities transactions while in possession of some types of undisclosed market information, however, the application of this standard of liability would accomplish the goals the court below sought to effectuate without up-

* *See, e.g., Zweig* v. *The Hearst Corp., supra,* CCH Fed. Sec. L. Rep. ¶96,851 (a financial columnist, who had received access to inside corporate information, utilized his newspaper column for the purpose of enhancing the profitability of his own securities trading activities; *cf.* Section 17(a) of the Securities Act, 15 U.S.C. §77q(a)); *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281 (C.A. 2, 1973) (a majority shareholder used its access to inside corporate information to effectuate the company's reorganization without disclosing adequately its plans to liquidate the company); *Reed* v. *Riddle Airlines*, 266 F.2d 314 (C.A. 5, 1959) (a corporate insider purchased stock without disclosing his knowledge of a third party's interest in the company); *Securities and Exchange Commission* v. *Healey*, Litigation Release No. 6589 (Nov. 18, 1974), 5 *SEC Docket* 524 (Dec. 3, 1974) (S.D. N.Y.) (consent decree) (an employer of tender offeror utilized knowledge of target company to make a profit from trades in target company stock); *In re Blyth & Company, Inc.*, 43 S.E.C. 1037 (SEC, 1969) (a securities professional traded on the basis of information obtained illegally from a government agency); *In re George J. Wunsch*, 44 S.E.C. 95 (SEC, 1969) (a securities dealer effected securities transactions for his own personal enrichment on the basis of information relating to both its customers' and employer's securities holdings). *Cf. United States* v. *Peltz*, 433 F.2d 48 (C.A. 2, 1970), *certiorari denied*, 401 U.S. 955 (1971) (trading on the basis of nonpublic information about forthcoming SEC enforcement actions).

setting the proper regulatory balance the Congress sought to achieve in adopting the Securities Exchange Act.*

CONCLUSION

Congress and the SEC, as discussed above, have continued to remain sensitive and attentive during the past few years to the important functions performed by market professionals; both have made considered efforts to avoid limiting the participation of market professionals by adopting rules which artificially or unnecessarily restrict their ability to perform their normal, and customary, trading activities. In contrast, the court below has rendered an interpretation of Rule 10b-5 that could, indeed, artificially restrict the valuable functions performed by market professionals. To that extent, the decision below runs afoul of the Court's admonition just this Term that the federal courts are simply "not at liberty to legislate" a different result from the one Congress has ordained.*

For the foregoing reasons, therefore, the Association urges this Court not to endorse the test of Rule 10b-5 liability articulated by the court below.

Respectfully submitted,

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* In a number of cases, Rule 10b-5 liability has been asserted against market professionals who have abused market information obtained as a result of access to, or a relationship with, the issuer of the securities that were purchased or sold. *See, e.g., United States* v. *Re*, 336 F.2d 306 (C.A. 2), *certiorari denied*, 379 U.S. 904 (1964) (specialist who traded in one of its specialty stocks as part of a manipulation by the issuer of that stock); *In re Albert Fried & Co. and Albert Fried, Jr., supra* ("the specialist impliedly represents that he will not take advantage of his unique position and his customers' ignorance of market conditions nor exploit that ignorance to extract unreasonable profits"); *Fridrich* v. *Bradford*, 542 F.2d 307 (C.A. 6, 1976), *certiorari denied*, 429 U.S. 1053 (1977) (over-the-counter market makers may not trade on the basis of inside information obtained through access to the issuer); *cf. Schonholtz* v. *American Stock Exchange, Inc.*, 505 F.2d 699 (C.A. 2, 1974); *Securities and Exchange Commission* v. *Resch-Cassin & Co., Inc.*, 362 F. Supp. 964 (S.D. N.Y., 1973); and *Securities and Exchange Commission* v. *Stern-Haskill, Inc.*, [1978 Decisions] CCH Fed. Sec. L. Rep. ¶94,065 (S.D. N.Y., 1973).

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* *Touche Ross & Co.* v. *Redington, supra*, 442 U.S. at ——, 47 U.S.L.W. at 4737.

FOR ARGUMENT

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IN THE

Supreme Court of the United States

October Term, 1979

No. 78-1202

VINCENT F. CHIARELLA,

Petitioner,

against

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY BRIEF

POINT I

The government's new theories of nondisclosure liability under Rule 10b-5 for an "outsider" such as Chiarella are baseless in law.

The government agrees that silence in connection with the purchase and sale of securities amounts to a Rule 10b-5 fraud only when the silence is in breach of an affirmative duty to speak. Yet at each point in this litigation—the

district court, the circuit and now in this Court—when called upon to sustain its position by a rational exposition of the law, the government has adopted a new theory and at the same time disavowed its prior reasoning. And, the district court's reasoning was rejected by the circuit court and the circuit's opinion, in effect, discarded by the Solicitor General here.

The theory of prosecution in the district court was that Chiarella was under the same duty as a classic "insider" to disclose material, nonpublic information to selling stockholders (Pet. App. B2). The law is clear, however, that such a duty to disclose arises only when the information originates or emanates from the issuer corporation (Pet. Br. 20-31). That nexus between the information and the issuer corporations is absent in this case and the government no longer argues to the contrary.

The theory used by the Second Circuit panel majority to affirm the conviction was that Chiarella, a "market insider" who "regularly receives material nonpublic information" (Pet. App. A7-A9), was, by virtue of his status, under a duty to disclose material, nonpublic information to selling shareholders. That theory, in conflict with this Court's decision in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 152-153 (1972), numerous positions taken by the SEC and the recognized legality of common activities of many professional traders who have "regular access to market information" (Pet. Br. 31-36), has effectively been abandoned by the government in this Court (Res. Br. 70, n.48).

The government in this Court advances two new theories it now claims give rise to Rule 10b-5 nondisclosure liability in the circumstances of this case:

> A. Chiarella breached a duty of loyalty owed to the offeror corporations by utilizing their information for personal profit without prior disclosure to the tender offeror of his intent to do so; his nondisclosure to the offeror was a fraud; and that fraud was somehow carried over to his purchase of securities from target shareholders (Res. Br. 28-38); and
>
> B. Chiarella's failure to disclose his information to the target shareholders breached a duty he owed them arising from the fact that his information was tortiously acquired and not accessible to the target shareholders (Res. Br. 38-72).

These newly advanced theories of liability, like the old ones, misconstrue the law.[1]

A. Chiarella's breach of a duty of loyalty he owed to the offeror corporations cannot form the basis of a Rule 10b-5 violation in connection with his purchases of stock from target shareholders.

The government's theory of liability based on Chiarella's breach of a duty of loyalty he owed the offerors conflicts with the law of agency, the law of torts and the securities laws.

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1. The government also argues that Rule 10b-5 plainly covers "all" frauds by "any" person and thus Chiarella's conduct is plainly embraced by the law (Res. Br. 25-28). The argument, in a classic bootstrap analysis, begs the issue in this case which is whether Chiarella's conduct amounts to a fraud within the meaning of Section 10(b) and Rule 10b-5.

1. *Anticipatory disclosure by an agent to his principal regarding an impending breach of duty is not required by agency law.*

We do not dispute the proposition that Chiarella violated his duty as an agent of the offeror corporations not to use their confidential information for personal profit. *See* Restatement, Second, Agency §395 (1958). But contrary to the government's assertion (Res. Br. 35), there is nothing in agency law requiring an agent contemplating such a breach of loyalty to disclose the impending breach to his principal.[2] Moreover, the disclosure suggested by the government, disclosure to the offeror corporations, aside from being a footless gesture, would not have provided any information to the target shareholders who sold Chiarella their shares.

2. *An agent's failure to disclose to his principal amounts to deceit only in the context of a transaction between agent and principal.*

Assuming, *arguendo,* that Chiarella breached some disclosure duty he owed to the offerors, nondisclosure in the context of an agency relationship amounts to deceit[3] only in the context of some transaction between principal and agent. As the Restatement, Second, Torts §551(2)(a)

2. If the agent seeks his principal's consent for a breach of the duty of loyalty, then, of course, the agent is duty bound to disclose all facts which might influence the principal's judgment in consenting. *See* Restatement, Second, Agency §390.

3. To label Chiarella's conduct toward the offerors a "fraud" is at best a dubious proposition. Not all conflicts of interest, not even those involving self-dealing by a fiduciary, amount to a fraud. *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462, 478 (1977). Chiarella's breach of duty to the offerors was unaccompanied by any misrepresentation or failure to discharge an obligation to disclose.

makes clear in defining when nondisclosure in the context of an agency relationship amounts to a fraud:

> "*(2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,*
>
> (a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them" (emphasis supplied).

Chiarella's "business transaction" was not with the offeror corporations and thus his failure to disclose his impending breach of duty to them was no fraud.[4] Although a fiduciary type relationship arguably can be said to have existed between Chiarella and the offeror corporations, there was no transaction between them. The transactions at issue in this case were between Chiarella and the target shareholders between whom there was no fiduciary relationship. There is and can be no authority for the government argument that the fiduciary responsibilities flowing from the relationship between Chiarella and the offerors may be imported into the transaction between Chiarella and the target shareholders.

3. *Chiarella's breach of duty owed to the offeror corporations was not "in connection with" any securities transaction.*

Even if Chiarella's failure to disclose to the offeror corporations his impending breach of duty owed them

4. Compare, *Sim* v. *Edenborn,* 242 U.S. 131 (1919); *Strong* v. *Repide,* 213 U.S. 419, 428-433 (1909); *United States* v. *Carter,* 217 U.S. 286, 305-310 (1910); *Wardell* v. *Railroad Company,* 103 U.S. 651, 654-659 (1880) (all cited by the government [Res. Br. 36, n.19]) where fraud findings were premised on nondisclosure in the context of a transaction between parties subject to the obligations of a fiduciary relationship.

could be considered a "fraud," *that fraud* was not "in connection with" Chiarella's stock transactions as required by §10(b) and Rule 10b-5. A fraud is "in connection with" a securities transaction under Rule 10b-5 only where the defrauded party is also the purchaser or seller of securities. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975); *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir. 1952).[5] As the *Birnbaum* court wrote in presaging the rule of *Blue Chip Stamps*:

> ". . . [Rule 10b-5 is] aimed only at 'a fraud perpetrated upon the purchaser or seller' of securities and [has] no relation to breaches of fiduciary duty by corporate insiders resulting in fraud upon those who were not purchasers or sellers." (*Id.*)

Here, the offeror corporations were neither buyers nor sellers of securities in any transaction with Chiarella. Any claim of "nondisclosure" the offerors might have against Chiarella is "in connection with" their utilization of Chiarella to do confidential printing work; his nondisclosure to the offerors has no nexus at all to the decision of the target shareholders to sell their stock. *Affiliated Ute Citizens* v. *United States, supra*, 406 U.S. at 153-154; *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 384 (1970); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969); *O'Brien* v. *Continental Illinois National Bank*, 431 F. Supp. 292, 296 (N.D.Ill. 1977).

5. The government cites *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971), for the proposition that as long as a fraud "touches" a securities transaction the "in connection with" requirement is satisfied (Res. Br. 37). But *Bankers Life* does not detract from the purchaser-seller requirement of *Blue Chip Stamps*; in *Bankers Life* the defrauded party was the seller of securities.

B. Neither Chiarella's mere possession and use of material nonpublic information nor his means of acquiring it gives rise to a duty to disclose to target shareholders.

The government maintains that Chiarella's use of information which was "not 'equally accessible'" to the target shareholders gives rise to a duty to disclose to those shareholders (Res. Br. 40). A pure and simple failure of a buyer to disclose facts inaccessible to a seller is and always has been a most unlikely basis for liability under the common law.[6] *See* Note, *Rule 10b-5: Scope of Liability Extended as Former Outsiders Become Market Insiders*, 58 Neb. L. Rev. 866, 871-76 (1979); Goldfarb, W. B., *Fraud and Nondisclosure in the Vendor-Purchaser Relation*, 8 W. Res. L. Rev. 5, 26-31 (1956). What is certain though is that open market trading on the basis and without disclosure of nonpublic information is not a Rule 10b-5 fraud.[7] *See, e.g., General Time Corp.* v. *Talley Industries,*

6. The common law cases on this issue are hardly uniform in their holdings or rationales. *Compare Laidlaw* v. *Organ*, 15 U.S. (2 Wheat.) 177, 195 (1817) *with Fox* v. *Mackreth*, 2 Cox, Ch. 320, 30 Eng. Rep. 148 (1788). Significantly, the Restatement, Second, Torts §551 does not include inaccessibility of information to one party in a transaction as a circumstance requiring disclosure.

Moreover, the scope of Rule 10b-5 law is not coterminous with the common law evolution of the tort of deceit. *See, e.g., Blue Chip Stamps* v. *Manor Drug Stores, supra*, 421 U.S. at 744.

7. Indeed, the government acknowledges as much in agreeing with the position of the *amicus* "that Section 10(b) and Rule 10b-5 would not ordinarily prohibit market professionals from carrying on their securities business while in possession of confidential information . . ." (Res. Br. 70, n.48). The government's attempt to distinguish Chiarella from "market professionals" and tender offerors on the basis of their "legitimate interests" and "essential role in the market" (Res. Br. 63-71) flies in the face of *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977), where a lack of legitimate economic motive was ruled out as a basis for Rule 10b-5 liability.

The panel majority of the Second Circuit also agreed that utilization of inaccessible information was not the *sine qua non* for Rule 10b-5 fraud (*United States* v. *Chiarella*, Pet. App. A10).

Inc., 403 F. 2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969). It is not "unequal access" which gives rise to a disclosure obligation in 10b-5 cases, but rather the breach of a disclosure obligation stemming from some fiduciary relationship between the trader or the original source of information and the selling shareholder. *In the Matter of Cady, Roberts & Co.*, 40 S.E.C. 907, 911-912 (1961); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969); *cf.* Restatement, Second, Torts §551(2)(a). When that relationship does not exist, as in the case at bar, trading without disclosure of inaccessible information is no violaton of Rule 10b-5 (Pet. Br. 25-29).

The government finally claims that it is Chiarella's "tortious acquisition" of the inaccessible information from the offerors which imposes upon him a duty to disclose that information to target shareholders (Res. Br. 41-42, 63-72). The government advances this theory in mistaken reliance on the wholly distinguishable English case of *Phillips* v. *Homfray*, L.R. 6 Ch. 770, 779-780 (1871). Pivotal in that case was the fact that the buyer obtained his undisclosed information by tortiously acquiring the information from *the seller*. Contrariwise, the target shareholders in the instant case cannot be heard to say that the claimed tortious conduct by Chiarella was inflicted on them. Moreover, it was not Chiarella's "acquisition" of the information which was wrongful—he necessarily obtained it legitimately in the course of his employment. Chiarella's "wrongful" conduct was using the information which amounts to a conversion against the offerors, *not* the selling target shareholders. There is nothing in the common

law to support the proposition that a conversion committed against one party gives rise to a disclosure obligation to an unrelated third party. From the point of view of the selling target shareholders, the result is the same whether the buyer commits a conversion against the offeror in using the information or is a consensual tippee like an institutional trader who engages in "warehousing." The point is that in neither case is there any fiduciary relationship with the selling shareholders giving rise to a duty to disclose.

In any event, it may modestly be said that Rule 10b-5 and the case law development of it does not unambiguously and with clarity impose an obligation to disclose on a trader who in utilizing nonpublic information commits a conversion on a third party not the seller, has no relationship whatever with the seller, and whose information does not emanate from the issuer. Since "ambiguity concerning the ambit of criminal statutes should be resolved in favor of lenity" (*Rewis* v. *United States*, 401 U.S. 808, 812 [1971]), theories of liability which are ambiguous at best cannot justify an interpretation of Rule 10b-5 to affirm Chiarella's conviction.

POINT II

Chiarella's conduct cannot, consistent with due process, form the basis of a criminal conviction where none of the proffered theories of liability was charged to the jury and such theories are an unpredictable departure from settled law.

As submitted in petitioner's brief in chief, this prosecution violated his right to fair notice (Pet. Br. Point II).

Similarly, the two new theories of liability advanced for the first time by the government in this Court—even if held by the Court in deciding this case to be correct, and we submit that they are not (Point I, *ante*)—simply find no basis in prior Rule 10b-5 law. As with the Second Circuit's "market insider" theory of liability, the government's latest theories may not be applied here to affirm Chiarella's conviction. *Bouie* v. *City of Columbia,* 378 U.S. 347, 352-354 (1964).

Moreover, the jury that convicted Chiarella was never charged that it must find facts now essential to the government's newly advanced theories of liability: there was no charge about a failure to disclose to the offeror corporations (the non-disclosure charge given had to do with the selling shareholders [R.884]); nor was there a charge requiring a finding that Chiarella tortiously acquired his information. "As a result, the Government's proposed interpretation of [Rule 10b-5] cannot be employed to uphold these convictions." *Rewis* v. *United States,* 401 U.S. 808, 814 (1971).

That Chiarella's conduct was not "clearly and unambiguously" prohibited by §10(b) and Rule 10b-5 is perhaps best evidenced by the numerous conflicting and novel theories advanced by the government throughout this litigation in seeking and attempting to uphold the conviction, the disagreements expressed by the four judges who have reviewed this case and the lengthy list of law review articles and other published comment about it.[8] It defies rudimentary fairness to suggest as the government does here that §10(b) and Rule 10b-5 "provide the clearest possible warning" (Res. Br. 73) that Chiarella's conduct was within their embrace when at the same time the government disavows the Second Circuit's theory of liability and offers for the first time ever two new theories of Rule 10b-5 liability.

POINT III

The trial court erred in failing to charge specific intent to defraud or deceive as an essential element of a Rule 10b-5 violation.

The government argues that *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976), does not require specific intent to deceive, manipulate or defraud as the requisite mental element of a Rule 10b-5 violation and that a jury charge requiring a finding that the defendant acted willfully and knowingly "fully comports with the requirements of *Hoch-*

8. Note, *Securities Regulation, United States* v. *Chiarella,* 13 Ga. L. Rev. 636 (1979); Comment, *The Application of Rule 10b-5 to "Market Insiders": United States* v. *Chiarella,* 92 Harv. L. Rev. 1538 (1979); Note, *Rule 10b-5: Scope of Liability Extended as Former Outsiders Become Market Insiders,* 58 Neb. L. Rev. 866 (1979); Brodsky, E., "Trading on Non-Public Market Information," N.Y.L.J., Sept. 19, 20, 1979.

felder" (Res. Br. 82-86). The essence of the government position is that the Court did not mean what it said in *Hochfelder*. But there can be no question that the holding of *Hochfelder* is that in a civil action for damages under Rule 10b-5 the plaintiff must plead and prove "specific intent to deceive, manipulate or defraud."[9]

Mr. Justice Powell could not have been clearer when he wrote (*id.* at 193):

> "We granted certiorari to resolve whether a private cause of action for damages will lie under §10(b) and Rule 10b-5 in the absence of any allegation of 'scienter' —intent to deceive, manipulate, or defraud. 421 U.S. 909, 95 S. Ct. 1557, 431 L. Ed. 2d 773 (1975). We conclude that it will not and therefore we reverse."

The holding in *Hochfelder* was based on this Court's view that the language of §10(b) "connotes intentional or willful conduct *designed to deceive or defraud investors* . . ." (*id.* at 199). (Emphasis supplied.)

Such specific intent is much different from the general criminal intent required by §32(a) ("knowingly and willfully") which was charged (Pet. Br. 50-51).

The government also takes issue with petitioner's request to charge defining the element of specific intent to defraud (Res. Br. 86-88). Such an argument is at best disingenuous. To be sure, Chiarella did request an instruction which sought to amplify the concept of "intent

9. The government misses the point in turning to law dictionaries for definitions of "scienter" (Res. Br. 82, n.61). Although the term "scienter" embraces many mental states as a general proposition, the brand of "scienter" required by *Hochfelder* is specific "intent to deceive, manipulate or defraud."

to defraud." But entirely separate and apart from that request, Chiarella also specifically requested an "intent to defraud" instruction *simpliciter*. Thus, Chiarella specifically requested the trial court to instruct that the jury acquit unless it found beyond a reasonable doubt that Chiarella acted "with the intent to defraud or deceive." (Petitioner's Request No. 14).

POINT IV

The government's restrictive reading of the confidentiality provisions of the New York Labor Law and the policies upon which it is based is in direct conflict with the plain language of the statute and the decisional law enforcing it.

As the government correctly points out, the unambiguous language employed in Section 537(1) of the New York Labor Law is the focal point of our argument in Point IV of our brief. And yet, in its effort to refute our initial premise, the government asks this Court to ignore the clear language it has carefully highlighted for the Court's attention.

While the government apparently concedes that Chiarella's statement falls within the statutory privilege, the government makes much of the fact that the statute does contain exceptions to the prohibition on (a) disclosure of the information by the Commissioner of Labor and (b) of its admission in the state courts (Res. Br. 89). Not once, however, does the government suggest how those exceptions apply to the instant case. The plain fact is that not one of the exceptions set out and italicized in the govern-

ment's brief has even the remotest application to the facts at hand.

First, the statute unmistakably bars the Commissioner of Labor, who administers the State Unemployment Insurance program, from disclosing information supplied by an employee, like Chiarella, who seeks benefits under the program. Section 537(1) provides but one narrow exception to this disclosure prohibition: the Commissioner may reveal the required information if it is material to the determination of the claim for benefits and, in those cases, such disclosure is limited to the "parties affected" by the claim or to the parties affected "in connection with effecting placement."

Surely, this language may not be read to contain legislative authorization for the Commissioner to release the information supplied by Chiarella to the Federal Bureau of Investigation, an agency unaffected by the "claim for benefits" or "in effecting placement." Accordingly, when, as claimed here, the Commissioner did approve the release of the privileged information to the FBI, he was acting in clear violation of the statute.[10]

Second, and of paramount importance, it is quite clear that regardless of whether the Commissioner's approved *disclosure* of the information was authorized, the fact

10. Indeed, the only significance of the Commissioner's alleged approval for the release of the petitioner's statement is that, under subsection 2 of Section 537, that approval provided a valid defense to any criminal prosecution for those persons who actually disclosed the information. Although the Commissioner's approval of the disclosure in this case may bar a criminal charge, it in no way legitimizes the Commissioner's action, which, as we have shown, was unauthorized in the first instance.

remains that the information disclosed would not be *admissible* in the courts of New York State. In express terms the legislature provided that the information provided by an employee "shall not . . . be used in any court in any action or proceeding pending therein." The legislature carefully delineated one exception to the rule, that is, where the "commissioner is a party to such action or proceeding." As with the other exceptions employed by the legislature, this one is totally inapplicable to the instant case. Not surprisingly, the state cases which have considered these confidentiality provisions and the exceptions (Pet. Br. 55-56), have uniformly barred admission of such statements as required by the explicit legislative mandate. Nor does the government even attempt to distinguish or in any way undermine these cases.

In sum, New York law prohibited both disclosure and subsequent admission of Chiarella's statement to the Department of Labor. Under these circumstances, to suggest, as the government does, that the use of Chiarella's statement at trial will not violate the state law and frustrate the policies underlying it is quite simply absurd (Res. Br. 90). This strong and clearly expressed legislative resolve to protect the confidentiality of Chiarella's statement should be honored in the federal courts. The federal interests which support federal recognition of the privilege are fully set forth in our main brief and need not be repeated here.

Conclusion

For the above reasons and the reasons presented in petitioner's brief in chief, the judgment of the Court of Appeals for the Second Circuit should be reversed with instructions to dismiss the indictment.

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Respectfully submitted,

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